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IMPACT OF BROKERED DEPOSITS ON BANKS AND THRIFTS: RISKS VERSUS BENEFITS

HEARING

BEFORE THE

SUBCOMMITTEE ON
GENERAL OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

JULY 16, 1985

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IMPACT OF BROKERED DEPOSITS ON BANKS AND THRIFTS: RISKS VERSUS BENEFITS

TUESDAY, JULY 16, 1985

House of Representatives,
Subcommittee on General Oversight
and Investigations,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 9:40 a.m., in room 2128, Rayburn House Office Building, Hon. Carroll Hubbard, Sr. (chairman of the subcommittee) presiding.

Present: Chairman Hubbard; Representatives Gonzalez, Barnard, Parris, Wortley, Dreier, and Chandler.

Chairman Hubbard. This morning, the Subcommittee on General Oversight and Investigations of our House Banking, Finance and Urban Affairs Committee will conduct a hearing and take testimony on the utility of brokered deposits and the question of their role as an enhancer of risk, and potential exposure to loss, to our financial institutions and our networks of Federal deposit insurance.

The sudden downfall of numerous financial institutions, and you are aware of the list of failures which continues to grow on a near daily basis, has necessitated countless investigations, studies and analyses of the failed institutions in an effort to determine the causes of failure of banks and thrifts, and to prevent further failures of our financial institutions across the Nation.

One recurring and controversial issue continues to be brokered deposits. Without detailing any particular role that brokered deposits may or may not have played in any of those failures, let me say at this point it must be precisely determined what additional risk, if any, their presence in depository institutions poses to enhance the exposure to loss to Federal deposit insurance.

An additional issue which has evolved from the consideration of the risk factor involves the propriety of providing Federal insurance for brokered funds at all. We certainly need to make a sound determination of what our Federal policy is regarding deposit insurance. In fact, deposit insurance and the condition of the Federal insurance funds, both FDIC and FSLIC, are subjects about which our subcommittee and our House Banking Committee are keenly interested.

Are we presently providing Federal insurance for multimillion dollar private business ventures; and if so, is that what our Federal policy presently dictates or should dictate? Please understand that I am not, in posing these questions, making any conclusions or casting any dispersions on what we believe. We simply must consider the issue from all aspects.

We of this subcommittee are patently aware that the issues involved here today have been the subjects of hearings in both the House and our companion body. Further, we are cognizant of the positions previously taken by you, our witnesses today, toward these issues. We have seen vastly different and opposing viewpoints from the standpoints of the regulators versus private industry, and we feel the causes of that divergence must be explored in further detail.

Our function as the Subcommittee on General Oversight and Investigations is to delve into a controversial subject such as brokered deposits that can and does have an enormous effect on the financial industry.

It is our duty to weigh the risk of brokered deposits to the well being of Federal deposit insurance and private industry versus the benefits of brokered deposits to all segments of society.

We are not at this point partisan to any particular faction or ideal, but rather deem it necessary to gather information here today from the most knowledgeable and astute sources available today, to assist us in drawing some rational conclusions about the efficacy and advisability of the continuing use and Federal insuring of brokered deposits.

Before I recognize my friend and colleague, Congressman Stan Parris, the ranking minority member of the subcommittee, I would like to welcome our witnesses to today's hearing: William M. Isaac, Chairman of the Federal Deposit Insurance Corporation, a man that Kentuckians are very proud of; H. Joe Selby, Acting Comptroller of the Currency; Shannon Fairbanks, Executive Staff Director and Chief of Staff of the Federal Home Loan Bank Board; Emanuel Falzon, president of Merrill Lynch Money Markets, Inc., of New York, NY; Raymond Thomas, first vice president/general counsel, and Dick Reibman, managing director, both of Dean Witter Reynolds, Inc., of New York, NY; Bill Goldsmith, executive vice president of Professional Asset Securities, Inc., of Del Mar, CA; and Jorge H. Coloma, president of FAIC Securities, Inc., of Miami, FL.

At this time we will ask Congressman Parris for his remarks.

Mr. PARRIS. I was interested that 3 million in Kentucky think very highly of Chairman Isaac, what do the other 3 million think?

Chairman HUBBARD. We have 3,010,000 in Kentucky.

Mr. PARRIS. That was a wild stab at humor this morning, Mr. Chairman.

While there has been much discussion in the Congress recently about brokered deposits, I do not believe we have adequately addressed the impact these deposits have on our Nation's banks and thrifts. There have been some recent judicial actions affecting proposed regulations on brokered deposits and other developments that we should consider in our evaluation of the risks and the benefits of these deposits.

In the past, individuals and institutions with funds to be invested in a bank or thrift institution savings account have dealt directly with the bank or thrift of their choice. More recently, both individual and institutional depositors have begun making much greater use of deposit brokers as their agents or intermediaries to put their money into a bank or thrift for them.

By using brokers, depositors are able to obtain a better interest return than they could get from local institutions. In most instances, there is also a high degree of safety for these funds. Federal deposit insurance provides safety for all deposits of $100,000 or less at a single institution.

I would like to make it clear that I, as one Member of the Congress, am not opposed to the use of brokered deposits or the practice of brokered deposits per se. I also do not support denying brokered funds to sound institutions that use them in a prudent manner. The operable word in that sentence is "sound institutions." Maybe the second one is prudent.

I have some serious concerns, however, about the current use of brokered deposits and their implications for many financial institutions and our Federal insurance programs and the solvency thereof.

The Federal Deposit Insurance Corporation has reported that 69 of the FDIC-insured banks that failed during 1982 to 1984 held over $1 billion in fully insured brokered deposits, increasing the FDIC's losses by hundreds of millions of dollars. Of $24 billion in both insured and uninsured brokered funds in all FDIC-insured institutions, the FDIC states that more than $9 billion were held by those rated as problem or marginal institutions.

The regulators have also claimed that troubled banks and thrifts use brokered funds more frequently and more extensively than well-rated institutions. These institutions tend to pay the highest rates, and brokered funds naturally flow to the highest bidders. It has been stated that a bank or thrift's strength or weakness is of only secondary concern to a broker because there is no risk to the broker or its customers. The risk just gets passed on to the FDIC and thereby to the system and to the taxpayer and to the Nation as a whole.

In an effort to address this situation, the FDIC and the Bank Board had issued a regulation to limit deposits placed by brokers to $100,000 per broker per insured institution. This regulation, as I understand, was struck down in Federal court. It is my understanding that the regulators have also been seeking legislation from Congress to deny deposit insurance coverage for credit unions, banks, and savings and loans that place their excess funds directly in other insured institutions.

Mr. Chairman, I look forward to having an opportunity to examining that question with the witnesses after hearing their testimony.

After hearing from our distinguished witnesses, I am optimistic that the subcommittee will be able to identify some acceptable options. It is my hope that we can devise a method of permitting the continued use of brokered deposits without posing a risk to our insurance funds.

I think, as I have indicated earlier in this statement, that it would be inadvisable to in some way prohibit or eliminate the use of this process, but we simply cannot continue to persist as it is now being utilized.

Thank you, Mr. Chairman. I look forward to hearing from these witnesses.

Chairman HUBBARD. Thank you, Congressman Parris.

I appreciate the cooperation of Congressman Parris this year as we have tried to move this subcommittee forward to being more active than we have had the opportunity to do in the past.

We welcome our friend, Bill Isaac, the distinguished Chairman of the Federal Deposit Insurance Corporation and ask for your testimony.

STATEMENT OF WILLIAM M. ISAAC, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. ISAAC. Mr. Chairman, I request that my whole statement be made part of the record.

Chairman HUBBARD. Without objection, so ordered.

Mr. ISAAC. Let me commend you for conducting this hearing on deposit brokerage activities, a subject of vital concern to the FDIC. The indiscriminate placement of fully insured brokered funds into troubled banks and thrifts is without question a threat to the viability of the deposit insurance system.

Just over 50 years ago, the financial system lay in ruin. Nearly 10,000 banks had failed during the first 4 years of the Great Depression, President Roosevelt had declared a bank holiday and the public clamored for reform. Over 100 proposals for a Federal deposit insurance system had been introduced in Congress during the late 1800's and early 1900's, but none had become law.

The political climate changed dramatically in the midst of the chaos, though there was still powerful opposition to Federal deposit insurance, most notably from President Roosevelt and the American Bankers Association. They believed the system would be too expensive and would subsidize marginal, high-risk institutions at the expense of well-managed firms. But millions of individuals had lost or faced the prospect of losing some or all of their life savings. They wanted action, not excuses. They wanted protection, not philosophy. Their voices were heard; the FDIC was created to restore confidence and stability in the banking system by safeguarding the savings of depositors, up to $2,500 per customer.

The system worked remarkably well. The holiday was ended and the failure rate plummeted. The fears expressed by opponents of deposit insurance did not come to pass. Bankers and their regulators, freshly scarred by the financial collapse, were extremely conservative. Competition, innovation and service were eschewed out of an overzealous concern for safety.

Driven by advances in technology, a violatile and changing economic environment, a growing sophistication on the part of investors and heightened competition, the financial world has undergone a virtual revolution during the past two decades. The signal event with respect to the problem at hand—deposit brokerage—was the passage of the Deregulation and Monetary Control Act of 1980, mandating the phaseout of deposit interest rate ceilings.

Prior to decontrol of interest rates, banks and thrifts were pretty much prohibited from bidding for deposits. Funds generally flowed to institutions that were perceived to be strong and could offer the best and most convenient services.

Overall, deregulation of interest rates has been an enormous success. Banks and thrifts have stopped the erosion of their market share dead in its tracks, and consumers and smaller businesses have reaped tens of billions of dollars in additional interest income. The fears expressed by some that rate wars and cutthroat competition would ensue have proved to be largely unfounded.

A major exception to this generally positive record involves the activities of money brokers and their investor clients. In a few short years, money brokering has become a very big and enormously lucrative business. It requires no particular skill apart from salesmanship. Money brokers scour the country in search of hot money seeking the highest available risk-free return. The funds are packaged in fully insured blocks and then sold to the highest bidder, which all too often is a marginal, high-risk institution. A survey conducted by the FDIC, as Congressman Parris just noted, last year revealed that of the $24 billion in brokered funds in FDIC-insured institutions, over $9 billion was held by troubled institutions.

Let me explain how the system works. Suppose a credit union has $10 million it wishes to invest in the money markets rather than lend to its customers. If there were no deposit insurance system, the credit union would likely invest in Treasury obligations, high-grade State or municipal bonds or high-quality bank or thrift CD's. Yield would be balanced against risk.

No such deep thought is required in the area of deregulation and the money broker. The credit union simply wires the $10 million to a broker and the broker in turn wires it in fully insured $100,000 blocks to the 100 banks and thrifts offering the highest rates. The entire transaction is completed nearly instantaneously—no muss, no fuss, and most importantly, no risk to anyone but the FDIC or the FSLIC.

The worst fears of the early opponents of deposit insurance are coming to pass. Marginal, high-risk banks and thrifts are being subsidized by well-run institutions, and the costs are staggering.

Attached to our statement as schedule A is a list of all FDIC-insured institutions using brokered deposits that failed from January 1, 1982, to July 12, 1985, showing, where available, the amount and percentage of brokered funds, the names of the brokers, and the sources of the funds placed by the brokers.

The brokered funds ranged as high as 76 percent of deposits. In all, they totaled nearly $1.1 billion in 80 banks. There is no question that use of brokered funds in these banks has cost the FDIC hundreds of millions of dollars.

Schedule B attached to our statement gives a brief case history of several of these banks. While they represent some of the more egregious examples of abuse, they are but a handful of the many examples we and the FSLIC could provide.

We should point out that some brokers are also involved in supplying funds to banks in amounts over the $100,000 insurance limit. If the CD is not subsequently subdivided among various investors so as to obtain full insurance coverage, we have no objection to this practice. In this situation, the broker and/or the broker's customers must perform a credit analysis, measuring the risk versus the yield, instead of blindly relying on our insurance guarantee.

The FDIC recently completed a survey of all FDIC-insured banks and thrifts rated three, four, and five—the lowest categories on our CAMEL rating system—which had fully insured brokered deposits in excess of 5 percent of their deposits. We were interested in looking at a number of aspects and specifically sought to determine who supplied these funds and how each of the troubled institutions was utilizing the FDIC-insured brokered deposits.

We were able to identify more than $2.3 billion in fully insured brokered deposits placed in more than 70 troubled institutions. The brokered funds ranged from just over 5 percent to almost 50 percent of the sampled institutions' deposits. In one instance, a major brokerage firm, in less than a week, placed $60 million in new funds in a clearly troubled FDIC-insured savings bank, which used the funds to speculate in "junk" bonds.

Schedule C, appended to our statement, identifies the 25 largest suppliers of fully insured brokered deposits to these weak and risky banks and thrifts. You will note that some of the Nation's largest financial services organizations are heavily involved in funneling fully insured investment moneys to these institutions.

Keep in mind that this survey occurred after nearly 2 years of intense efforts by the FDIC to control this clear abuse of the deposit insurance system. It is frightening to contemplate how much more massive the problem might have become in the absence of these efforts.

It is a simple fact that troubled banks and thrifts use brokered funds more frequently and more extensively than well-rated institutions. These institutions tend to pay the highest rates, and brokered funds flow to the highest bidders. Our studies have revealed that troubled banks are twice as likely as all banks as a group to hold significant amounts of insured brokered funds.

Who are the principal investors in brokered funds? Credit unions were identified as the largest single aggregate dollar holders, followed by S&L's and commercial banks. Frankly, we find it appalling that the biggest abusers of the deposit insurance system are the very institutions the system was designed to assist.

The FDIC has addressed the problem of brokered deposits by regulation and, in individual cases, by use of our supervisory and enforcement powers. We issued a regulation limiting Federal deposit insurance coverage for all deposits placed by or through brokers to $100,000 per broker, per insured institution. As you are aware, however, our 1984 joint effort with the Federal Home Loan Bank Board to accomplish this is being challenged in the courts.

We have also dealt with the problems resulting from brokered deposit use on a case-by-case basis. When abuses are found, we use our enforcement powers to guard against further deterioration. For nearly 2 years now, as a matter of routine, we have inserted a provision in all enforcement actions taken against three-, four-, and five-rated institutions prohibiting further usage of brokered funds.

While our vigorous enforcement activities have had a limiting effect on brokered deposit use, I would stress that these actions are not preventive measures. They are, of necessity, initiated after the fact when problems and clear abuse have already been identified.

In January of this year, the FDIC instituted a monthly reporting requirement for all FDIC-insured banks and thrifts holding fully insured brokered deposits and financial institution deposits in excess of either the institution's capital or 5 percent of deposits. These reports help, but they are not the sole answer. They give us better information.

We recently began publicly disclosing the names of financial institutions placing funds in failed banks and thrifts. Our aim is to focus attention on the fact that brokered and financial institution deposits are all too often placed in institutions offering the highest rates, without regard for the soundness of the issuing institution. The point must be driven home that when these institutions fail, the cost to the deposit insurance fund is greatly increased.

We have received virtually no help from the Congress during the past 2 years as we have struggled to contain this serious threat to the insurance system. A subcommittee in the House—not this one—issued two studies contending there is no problem despite overwhelming facts to the contrary. Last year the Senate passed a bill that would have literally tied both hands behind our backs by establishing an exceedingly high cap on shorter term brokered deposits, exempting longer term funds altogether and restricting our current enforcement powers over troubled institutions.

The FDIC's joint regulation with the Bank Board to limit deposit insurance coverage of brokered funds is, in our view, the simplest and by far the most preferable alternative for dealing with the brokered deposit problem. It does not prohibit any bank or thrift from using brokered funds or any broker from placing funds; there is absolutely no interference with the functioning of the marketplace. Funds will flow only to those institutions with a balance sheet strong enough to inspire investor confidence. The validity of this regulation should be affirmed by the Congress and coupled with a law denying deposit insurance coverage for funds placed in other insured institutions by credit unions, banks, and S&L's.

Though the brokerage houses like to portray themselves as champions of the free-enterprise system, they are opposed to this market-oriented approach. They would prefer that if we are going to do anything, we regulate the flow of funds through a law placing a cap on the amount of brokered deposits any institution may receive. While we do not like it, we can accept such a bill so long as the cap is reasonable and so long as the law does not in any way impinge on our current authority to prohibit the use of any brokered funds by troubled institutions.

No bank or thrift should be able to leverage upon the Federal guarantee with insured brokered deposits in a volume greater than that which its owners have at risk. The cap for insured brokered deposits should thus be limited to 100 percent of an institution's capital. When you consider that FDIC-insured institutions currently hold $24 billion in both insured and uninsured brokered funds and that a limit of 100 percent of capital would allow nearly $190 billion in fully insured brokered funds alone, this limit is more than generous and ought to satisfy the fee-generating appetite of the brokerage industry for years to come.

The limit must apply to any deposits placed by or through a broker regardless of maturity. Some suggest that longer-term brokered funds—those with maturities of 1 year or more—ought to be of less concern to the FDIC because they represent a more stable funding source to a depository institution than do short-term funds. There is absolutely no justification for a distinction between long-term and short-term brokered deposits.

Maturity is not the relevant problem. Fully insured brokered deposits of any maturity provide almost limitless funds to a bank or thrift which can be misused without risk to the broker or investor.

I would point out that the bulk of the funds supplied to troubled banks by the major investment firms have a maturity in excess of 1 year. How much more do these brokers need than a ceiling of $190 billion for FDIC-insured banks and thrifts, not to mention FSLIC-insured institutions? A ceiling that will likely grow by 8 to 10 percent per year as capital increases. A ceiling that is nearly eight times greater than the amount of all brokered funds, insured and uninsured, in these institutions today. A ceiling that is over ten times the size of the FDIC's insurance fund!

Thank you once again, Chairman Hubbard and members of this subcommittee, for giving us this opportunity to express our views on an issue of great importance to the Nation's financial system. I will be pleased to respond to any questions you may have.

[The prepared statement of Mr. Isaac on behalf of the Federal Deposit Insurance Corporation follows:]

A STATEMENT ON

BROKERED DEPOSITS

PRESENTED TO THE

SUBCOMMITTEE ON GENERAL OVERSIGHT
AND INVESTIGATIONS

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

BY

WILLIAM M. ISAAC, CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

Room 2128, Rayburn House Office Building
July 16, 1985
10:00 a.m.

Mr. Chairman, members of the subcommittee, let me commend you for conducting this hearing on deposit brokerage activities, a subject of vital concern to the FDIC. The indiscriminate placement of fully insured brokered funds into troubled banks and thrifts is without question a threat to the viability of the deposit insurance system.

An Overview of the Problem

Just over 50 years ago, the financial system lay in ruin. Nearly 10,000 banks had failed during the first four years of the Great Depression, President Roosevelt had declared a bank holiday and the public clamored for reform. Over a hundred proposals for a federal deposit insurance system had been introduced in Congress during the late 1800s and early 1900s, but none had become law.

The political climate changed dramatically in the midst of the chaos, though there was still powerful opposition to federal deposit insurance, most notably from President Roosevelt and the American Bankers Association. They believed the system would be too expensive and would subsidize marginal, high-risk institutions at the expense of well-managed firms. But millions of individuals had lost or faced the prospect of losing some or all of their life savings. They wanted action, not excuses. They wanted protection, not philosophy.

Their voices were heard; the FDIC was created to restore confidence and stability in the banking system by safeguarding the savings of depositors, up to $2,500 per customer.

The system worked remarkably well. The holiday was ended and the failure rate plummeted. The fears expressed by opponents of deposit insurance did not come to pass. Bankers and their regulators, freshly scarred by the financial collapse, were extremely conservative. Competition, innovation and service were eschewed out of an over-zealous concern for safety.

Driven by advances in technology, a volatile and changing economic environment, a growing sophistication on the part of investors and heightened competition, the financial world has undergone a virtual revolution during the past two decades. The signal event with respect to the problem at hand -- deposit brokerage -- was the passage of the Deregulation and Monetary Control Act of 1980, mandating the phaseout of deposit interest rate ceilings.

Prior to decontrol of interest rates, banks and thrifts were pretty much prohibited from bidding for deposits. Funds generally flowed to institutions that were perceived to be strong and could offer the best and most convenient services.

Overall, deregulation of interest rates has been an enormous success. Banks and thrifts have stopped the erosion of their market share dead in its tracks, and consumers and smaller businesses have reaped tens of billions of dollars in additional interest income. The fears expressed by some that rate wars and cutthroat competition would ensue have proved to be largely unfounded.

A major exception to this generally positive record involves the activities of money brokers and their investor clients. In a few short years money brokering has become a very big and enormously lucrative business. It requires no particular skill apart from salesmanship. Money brokers scour the country in search of hot money seeking the highest available risk-free return. The funds are packaged in fully insured blocks and then sold to the highest bidder, which all too often is a marginal, high-risk institution. A survey conducted by the FDIC last year revealed that of the $24 billion in brokered funds in FDIC-insured institutions, over $9 billion was held by troubled institutions.

Let me explain how the system works. Suppose a credit union has $10 million it wishes to invest in the money markets rather than lend to its members. If there were no deposit insurance system, the credit union would likely invest in

Treasury obligations, high-grade state or municipal bonds or high-quality bank or thrift CDs. Yield would be balanced against risk.

No such deep thought is required in the era of deregulation and the money broker. The credit union simply wires the $10 million to a broker and the broker in turn wires it in fully insured $100,000 blocks to the 100 banks and thrifts offering the highest rates. The entire transaction is completed nearly instantaneously -- no muss, no fuss and, most importantly, no risk to anyone but the FDIC or the FSLIC.

The worst fears of the early opponents of deposit insurance are coming to pass. Marginal, high-risk banks and thrifts are being subsidized by well-run institutions, and the costs are staggering. Attached to our statement as Schedule A is a list of all FDIC-insured institutions that failed from January 1, 1982, to July 12, 1985, showing, where available, the amount and percentage of brokered funds, the names of the brokers and the sources of the funds placed by the brokers. The brokered funds ranged as high as 76 percent of deposits. In all, they totalled nearly $1.1 billion in 80 banks. There is no question that use of brokered funds in these banks has cost the FDIC hundreds of millions of dollars. Schedule B attached to our statement gives a brief case history of several of these banks. While they represent some of the more egregious examples of abuse, they are but a handful of the many examples we and the FSLIC could provide.

We should point out that some brokers are also involved in supplying funds to banks in amounts over the $100,000 insurance limit. If the CD is not subsequently subdivided among various investors so as to obtain full insurance coverage, we have no objection to this practice. In this situation the broker and/or the broker's customers must perform a credit analysis, measuring the risk versus the yield, instead of blindly relying on our insurance guarantee.

The FDIC recently completed a survey (data as of February 28) of all FDIC-insured banks and thrifts rated 3, 4 and 5 -- the lowest categories on our CAMEL rating system -- which had fully insured brokered deposits in excess of five percent of their deposits. We were interested in looking at a number of aspects and specifically sought to determine who supplied these funds and how each of the troubled institutions was utilizing the FDIC-insured brokered deposits.

We were able to identify more than $2.3 billion in fully insured brokered deposits placed in more than 70 troubled institutions. The brokered funds ranged from just over five percent to almost 50 percent of the sampled institutions' deposits. In one instance a major brokerage firm, in less than a week, placed $60 million in new funds in a clearly troubled FDIC-insured savings bank, which used the funds to speculate in high-yield corporate (so-called "junk") bonds.

Schedule C appended to our statement identifies the 25 largest suppliers of fully insured brokered deposits to these weak and risky banks and thrifts. You will note that some of the nation's largest financial services organizations are heavily involved in funneling fully insured investment monies to these institutions.

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The Response to the Problem

The FDIC has addressed the problem of brokered deposits by regulation and, in individual cases, by use of our supervisory and enforcement powers. We issued a regulation limiting federal deposit insurance coverage for all deposits placed by or through brokers to $100,000 per broker, per insured institution. As you are aware, however, our 1984 joint effort with the Federal Home Loan Bank Board to accomplish this is being challenged in the courts.

We have also dealt with the problems resulting from brokered deposit use on a case-by-case basis. When abuses are found, we use our enforcement powers to guard against further deterioration. For nearly two years now, as a matter of routine, we have inserted a provision in all enforcement actions taken against 3, 4 and 5 rated institutions prohibiting further usage of brokered funds. While our vigorous enforcement activities have had a limiting effect on brokered deposit use, I would stress that these actions are not preventive measures. They are, of necessity, initiated after the fact when problems and clear abuse have been identified.

In January of this year, the FDIC instituted a monthly reporting requirement for all FDIC-insured banks and thrifts holding fully insured brokered and financial institution deposits in excess of either the institution's capital or five percent of deposits. This reporting requirement provides more frequent and meaningful information than had been available, and increases our effectiveness in dealing with the problems. Institutions reporting heavy usage of brokered funds are targeted for much more frequent inspections, as are those that show up on deposit listing services as paying above normal interest rates.

We recently began publicly disclosing the names of financial institutions placing funds in failed banks and thrifts. Our aim is to focus attention on the fact that brokered and financial institution deposits are all too often placed in institutions offering the highest rates, without regard for the soundness of the issuing institution. The point must be driven home that when these institutions fail, the cost to the deposit insurance fund is greatly increased.

All these measures have helped, but they cannot be expected to solve the problems. In an environment in which a bank or thrift may purchase a massive volume of funding overnight, an institution can radically and precipitously alter its character and its risk to the insurance fund.

Legislative Alternatives

We have received virtually no help from the Congress during the past two years as we have struggled to contain this serious threat to the insurance system. A subcommittee in the House issued two "studies" contending there is no problem despite overwhelming facts to the contrary. Last year the Senate passed a bill that would have literally tied both hands behind our back by establishing an exceedingly high cap on shorter term brokered funds, exempting longer term funds altogether and restricting our current enforcement powers over troubled institutions.

The FDIC's joint regulation with the Bank Board to limit deposit insurance coverage of brokered funds is, in our view, the simplest and by far the most preferable alternative for dealing with the brokered deposit problem. It does not prohibit any bank or thrift from using brokered funds or any broker from placing funds; there is absolutely no interference with the functioning of the marketplace. Funds will flow only to those institutions with a balance sheet strong enough to inspire investor confidence. The validity of this regulation should be affirmed by the Congress and coupled with a law denying deposit insurance coverage for funds placed in other insured institutions by credit unions, banks and S&Ls.

Though the brokerage houses like to portray themselves as champions of the free-enterprise system, they are opposed to this market-oriented approach. They would prefer that we regulate the flow of funds through a law placing a cap on the amount of brokered deposits any institution may receive. While we do not like it, we can accept such a bill so long as the cap is reasonable and so long as the law does not in any way impinge on our current authority to prohibit the use of any brokered funds by any troubled institution.

No bank or thrift should be able to leverage upon the federal guarantee with insured brokered deposits in a volume greater than that which its owners have at risk. The cap for insured brokered deposits should thus be limited to 100 percent of an institution's capital. When you consider that FDIC-insured institutions currently hold $24 billion in both insured and uninsured brokered funds and that a limit of 100 percent of capital would allow nearly $190 billion in fully insured brokered funds alone, this limit is more than generous and ought to satisfy the fee-generating appetite of the brokerage industry for years to come.

The limit must apply to any deposits placed by or through brokers regardless of the term or maturity. Some suggest that longer-term brokered funds -- those with maturities of one year or more -- ought to be of less concern to the FDIC because they represent a more stable funding source to a depository institution than do short-term funds. There is absolutely no justification" for a distinction between long-term and short-term brokered deposits. Maturity is not the relevant problem. Fully insured brokered deposits of any maturity provide almost limitless funds to a bank or thrift which can be misused without risk to the broker or investor. I would point out that the bulk of the funds supplied to troubled banks by the major investment firms have a maturity in excess of one year. How much more do these brokers need than a ceiling of $190 billion for FDIC-insured banks and thrifts, not to mention FSLIC-insured institutions? A ceiling that will likely grow by 8-to-10 percent per year as capital increases. A ceiling that is nearly eight times greater than the amount of all brokered funds, insured and uninsured, in these institutions today. A ceiling that is over 10 times the size of the FDIC's insurance fund!

Thank you once again Chairman Hubbard and members of this subcommittee for giving us this opportunity to express our views on an issue of great importance to the nation's financial system. I will be pleased to respond to any questions you may have.

* * * * *

SCHEDULE A

Brokered Deposits in Closed Banks
January 1, 1982 to July 12, 1985

(1) Metropolitan Bank and Trust Company, Tampa, Florida (2-6-82):
$13,515M (7%) - Credit Unions

First United Fund, Ltd., Garden City, N.Y.

(2) Aquia Bank and Trust, Stafford, Virginia (4-3-82):
$3,136M - Bureau of Indian Affairs
500M - Military Funds (Air Force Central)
$3,636M (29%)

FAIC Securities, Miami, Florida

(3) National Security Bank, Tyler, Texas (4-16-82):
$100M - Military Funds (U.S. Army)
200M - Dept. of Energy
$300M (3%)

Brokers unknown

(4) Pacific Coast Bank, San Diego, California (4-29-82):
$1,800M - Military Funds (Air Force Central, Marine Corps)
800M - Political Subdivisions
400M - Credit Unions
1,400M - Others
$4,400M (47%)

Century Hill Financial, Century City, CA
First United Fund, Ltd., N.Y.

(5) Citizens Bank, Tillar, Arkansas (6-23-82):
$522M (9%) - Bureau of Indian Affairs

Brokers unknown

(6) Penn Square Bank, N.A., Oklahoma City, Oklahoma (7-5-82):
$ 6,512M - Bureau of Indian Affairs
13,042M - Banks
12,951M - Savings and Loans
81,932M - Credit Unions
10,238M - Others
$124,675M (26%)

First United Fund, Ltd., N.Y.
Norman Werbner Associates, Houston, TX
Professional Asset Management, Del Mar, CA
Sun Capital Management, La Jolla, CA

(7) Western National Bank, Santa Ana, California (8-27-82):
$4,100M - Credit Unions
1,100M - Savings and Loans
1,900M - Political Subdivisions
200M - Military Funds (Marine Corp, Air Force)
1,000M - Others
$8,300M (40%)

Brokers unknown

(8) Hohenwald Bank and Trust Company, Hohenwald, Tennessee (9-3-82):
$200M (1%) - Military Funds (Air Force Central, Marine Corps)

Brokers unknown

(9) Tri-State Bank, Markham, Illinois (9-8-82):
$400M - Military Funds (Air Force Central, Marine Corps, Army)
100M - Credit Union
100M - Federal Milk Market Administration
$600M (4%)

Brokers unknown

(10) State Bank of Barnum, Barnum, Minnesota (2-9-83):
$4,432M - Bureau of Indian Affairs
1,068M - Military Funds (Marine Corps, Air Force)
$5,500M (40%)

Commonwealth Capital Corp., Charlottesville, VA

(11) American City Bank, Los Angeles, California (2-25-83):
$37,500M - Credit Unions
9,400M - Banks
7,900M - Savings and Loans
27,350M - Others
$82,150M (32%)

Professional Asset Securities, Del Mar, CA

(12) Newport Harbour National Bank, Newport Beach, California (3-11-83):
$16,600M - Credit Unions
4,800M - Banks
5,700M - Savings and Loans
3,400M - Political Subdivisions
255M - Bureau of Indian Affairs
3,201M - Others
$33,956M (75%)

Century Hill Financial, CA
Courtesy Deposits, Inc., Southfield, MI
Golconda Financial, San Marino, CA
Duncan Williams Government Securities Corp., Memphis, TN

E.R. Weston & Associates, Rolling Hills, CA
First United Fund, Ltd., N.Y.
International Investment Referral Service, Costa Mesa, CA
Kominz Company, Marina Del Rey, CA
National Money Market Services, Santa Ana, CA

(13) Pan American National Bank, Union City, New Jersey (3-18-83):
$4,806M - Bureau of Indian Affairs
1,200M - Credit Unions
600M - Banks
300M - Savings and Loans
100M - Other
$7,006M (21%)

Brokers unknown

(14) Bear Creek Valley Bank, Phoenix, Oregon (3-25-83):
$2,454M - Bureau of Indian Affairs
1,800M - Military Funds (U.S. Navy, Marine Corp. A.F.)
1,000M - Credit Unions
300M - Savings and Loans
200M - Banks
200M - Others
$5,945M (49%)

Bristol Investment Group, Inc., Coral Gables, FL
E.R. Weston & Associates, CA
First United Fund, Ltd, N.Y.

(15) Bank of San Marino, San Marino, California (4-8-83):
$1,100M - Credit Unions
900M - Political Subdivisions
400M - Banks
500M - Others
$2,900M (23%)

Century Hill Financial, CA

(16) Sparta-Sanders State Bank, Sparta, Kentucky (4-15-83):
$ 3,100M - Credit Unions
2,750M - Military Funds
1,947M - Bureau of Indian Affairs
1,400M - Banks
900M - Savings and Loans
2,346M - Others
$12,443M (76%)

Brokers unknown

(17) Heritage Bank, Ashland, Oregon (4-29-83):
$400M - Credit Unions
100M - Bank
100M- Savings and Loan
$600M (4%)

E.R. Weston & Associates, CA
FAIC Securities, FL
Golconda Financial, CA

(18) United American Bank in Hamilton County, Chattanooga, Tennessee (5-27-83):
$ 2,500M - Banks
700M - Savings and Loans
6,900M - Credit Unions
$10,100M (8%)

Brokers unknown

(19) City and County Bank of Roane County, Kingston, Tennessee (5-27-83):
$ 180M - Bureau of Indian Affairs
300M - Banks
700M - Credit Unions
100M - Savings and Loan
$1,280M (3%)

Brokers unknown

(20) City and County Bank of Anderson County, Lake City, Tennessee (5-27-83):
$ 180M - Bureau of Indian Affairs
1,700M - Banks
3,000M - Savings and Loans
14,800M - Credit Unions
300M - Others
$19,980M (23%)

Brokers unknown

(21) United Southern Bank of Nashville, Tennessee (5-27-83):
$ 6,355M - Bureau of Indian Affairs
3,100M - Banks
18,800M - Credit Unions
4,700M - Savings and Loans
3,000M - Others
$35,955M (36%)

FAIC Securities, FL

(22) City and County Bank of Knox County, Knoxville, Tennessee (5-27-83):
$ 6,221M - Bureau of Indian Affairs
7,900M - Banks
51,000M - Credit Unions
13,600M - Savings and Loans
8,009M - Others
$86,730M (48%)

Brokers unknown

(23) The Commercial Bank of California, Los Angeles, California (5-27-83):
$6,000M - Bureau of Indian Affairs
300M - Credit Unions
$6,300M (23%)

National Money Markets Services, CA

(24) Community Bank, Hartford, South Dakota (6-17-83):
$10,400M (27%) - Institutional Investors (Credit Unions, Banks and Savings and Loans)

First United Fund, Ltd., N.Y.

(25) Western National Bank of Lovell, Lovell, Wyoming (6-24-83):
$12,600M (64%) - Institutional Investors

First United Fund, Ltd, N.Y.

(26) Mineral Bank of Nevada, Las Vegas, Nevada (6-30-83):
$1,650M - Bureau of Indian Affairs
900M - Military Funds
600M - Banks
300M - Savings and Loans
1,100M - Others
$4,550M (41%)

Commonwealth Capital Corp., VA

(27) The First Central Bank, Smithville, Tennessee (7-8-83):
$600M (3%) - Military Funds

Brokers unknown

(28) First Peoples Bank of Washington County, Johnson City, Tennessee (7-29-83):
$ 5,818M - Bureau of Indian Affairs
50,470M - Institutional Investors
$56,288M (33%)

FAIC Securities, FL

(29) First Commerce Bank of Hawkins County, Rogersville, Tennessee (8-12-83):
$ 180M - Bureau of Indian Affairs
6,400M - Credit Unions
$6,580M (14%)

Brokers unknown

(30) United Southern Bank of Clarksville, Clarksville, Tennessee (8-26-83):
$3,156M - Bureau of Indian Affairs
400M - Others
$3,556M (33%)

Brokers unknown

(31) Douglas State Bank, Kansas City, Kansas (9-2-83):
$1,800M - Credit Unions
700M - Savings and Loans
$2,500M (11%)

Brokers unknown

(32) Warren County Bank, McMinnville, Tennessee (9-16-83):
$2,283M - Bureau of Indian Affairs
200M - Military Funds
2,100M - Credit Unions
$4,583M (24%)

Brokers unknown

(33) Dominion Bank of Denver, Denver, Colorado (9-30-83):
$ 500M - Banks
5,262M - Others
$5,762M (45%)

Brokers unknown

(34) National Bank of Odessa, Odessa, Texas (9-30-83):
$2,500M (3%) - Credit Unions

Brokers unknown

(35) The Deschutes Bank, Remond, Oregon (10-7-83):
$ 200M - Banks
700M - Savings and Loans
500M - Credit Unions
$1,400M (14%)

Bristol Investment Group, Inc., FL
First Empire Funding Corp., N.Y.

(36) First National Bank of Midland, Texas (10-14-93):
$75,672M (13%)

J.M. Lummus & Co.
Merrill Lynch Money Market, Inc.
Narragansett Venture Capital

(37) First National Bank of Browning, Browning, Montana (11-10-83):
$1,300M - Banks
1,200M - Savings and Loans
1,400M - Credit Unions
100M - Other
$4,000M (30%)

First United Fund, Ltd., N.Y.
John Brittenum & Associates, Inc., Little Rock, AR

(38) Atkinson Trust and Savings Bank, Atkinson, Illinois (11-22-83):
$3,356M (18%)

First United Fund, Ltd., N.Y.

(39) City & County Bank of Jefferson County, White Pine, Tennessee (1-21-84):
$180M - Bureau of Indian Affairs
100M - Savings and Loan
300M - Banks
$580M (3%)

Brokers unknown

(40) Indian Springs State Bank, Kansas City, Kansas (1-28-84):
$9,300M (34%)

Caray Investment Company, Inc. CA
First United Fund, Ltd., N.Y.
International Investment Referral Services, CA
Kominz Co., CA
National Money Market Services, CA

(41) Emerald Empire Banking Company, Springfield, Oregon (2-3-84):
$ 2,000M - Banks
1,800M - Savings and Loans
6,800M - Credit Unions
300M - Others
$11,000M (53%)

Caray Investment Company, Inc., CA
First Empire Funding Corp., N.Y.
First United Fund, Ltd., N.Y.
Long Beach Savings and Loan Association, CA
National Money Market Services, Inc.

(42) Tucker County Bank, Parsons, West Virginia (2-3-84):
$2,100M - Military Funds (Air Force Central, Marine Corps, Coast Guard)
200M - Savings and Loans
100M - Credit Union
1,057M - Bureau of Indian Affairs
100M - Other
$3,557M (24%)

Monetary Investment Co., Sioux Falls, S.D.

(43) United Bank of Oregon, Milwaukie, Oregon (3-2-84):
$ 200M - Savings and Loans
600M - Credit Unions
200M - Banks
550M - Others
$1,550M (11%)

Independent State Bank of Minnesota, Minneapolis, MN
National Money Market Service, Inc., CA

(44) All American National Bank, Virginia Gardens (P.O. Miami), FL (3-2-84):
$1,100M - Credit Unions
200M - Banks
500M - Savings and Loans
100M - Municipality
100M - Other
$2,000M (18%)

FAIC Securities, FL

(45) Seminole State National Bank, Seminole, Texas (3-16-84):
$200M - Credit Unions
100M - Savings and Loan
$300M (1%)

FAIC Securities, FL

(46) Heritage Bank, Anaheim, California (3-16-84)
$40,650M - Credit Unions
11,500M - Savings and Loans
18,200M - Banks
8,000M - Municipalities
5,819M - Bureau of Indian Affairs
14,219M - Others
$98,388M (64%)

First United Fund, Garden City, NJ
FAIC, Securities, FL
Kominz Company, CA
E.R. Weston & Associates, CA
National Money Market Services, CA
Golconda, CA
Duncan Williams, Government Securities, Corp., TN
First Empire, Funding Corp., NY
Caray Investments, CA
Long Beach Savings and Loan, CA
Bilmar, Upland, CA
Peninsula Savings, San Francisco, CA
TCD National Encino, CA
Bristol Investments, FL
CAL Investment, Costa Mesa, CA
TCS Brokerage, San Diego, CA
International Investments, Irvine, CA
Sun Capital Management, San Diego, CA

(47) Watauga Valley Bank, Elizabethton, Tennessee (4-6-84):
$1,100M - Credit Unions
300M - Banks
100M - Savings and Loan
188M - Bureau of Indian Affairs
200M - Others
$1,888M (14%)

FAIC Securities, FL
First United Fund, Ltd., N.Y.

(48) First Security Bank, Erwin, Tennessee (4-6-84):
$1,796M - Credit Unions
600M - Banks
400M - Savings and Loans
200M - Others
$2,996M (14%)

First United Fund, Ltd., N.Y.

(49) Security National Bank, Lubbock, Texas (4-13-84):
$3,397M (8%)

Harvey Baskin & Co., D.C.

(50) West Coast Bank, Los Angeles (Encino), California (4-17-84):
$19,298M - Banks
15,396M - Savings and Loans
32,792M - Credit Unions
16,625M - Others
$84,111M (52%)

National Money Market Services, Inc., CA
FAIC Securities, Inc., FL
First United Fund, Ltd., NY
Golconda Financial, CA
Kominz Company, Ltd., CA
High Yield Management, Inc., Clifton, NJ
Caray Investment Company, Inc., CA
Connie Tait Financial Services, Ventura, CA
Federally Insured Savings Network
International Investment Referral Service, CA
Investment Transaction Corporation, Los Altos, CA

(51) United of America Bank, Chicago, Illinois (4-26-84):
$300M (1%) - Credit Unions

First United Fund, Ltd., N.Y.

(52) First National Bank of Rushford, Rushford, Minnesota (5-4-84):
$360M (2%) - Banks

Independent State Bank of Minnesota, MN

(53) The National Bank of Carmel, Carmel-BY-The-Sea, California (5-8-84):
$11,300M - Credit Unions
2,200M - Banks
1,100M - Savings and Loans
14,830M - Others
$29,430M (39%)

First United Fund, Ltd., NY
National Money Market Services, Irvine, CA
Money Investment Services, CA
Investment Transaction Corporation, CA
FAIC Securities, FL
Connie Tait Financial Services, CA

(54) First Continental Bank & Trust Company of Del City, Del City, Oklahoma (5-1
$ 4,900M - Banks
12,000M - Credit Unions
2,800M - Savings and Loans
114M - Bureau of Indian Affairs
1,705M - Others
$21,519M (22%)

FAIC Securities, FL
First United Fund, Ltd., N.Y.
National Money Market Services, Inc., CA
Pacific Money Investments, Inc., Blaine, WA
Professional Asset Management, CA
TCD National, Inc., Encino, CA

(55) Bank of Irvine, Irvine, California (5-18-84):
$ 700M - Credit Unions
500M - Banks
200M - Others
$1,400M (5%)

Caray Investments, CA
Bell Savings and Loan Association, L.A., CA
First Empire Funding Corp., N.Y.
FAIC Securities, FL
Golconda Financial, CA

(56) First National Bank of Prior Lake, Prior Lake, Minnesota (5-24-84):
$ 300M - Banks
1,700M - Credit Unions
300M - Savings and Loans
200M - Others
$2,500M (19%)

First United Fund, Ltd., N.Y.

(57) Garden Grove Community Bank, Garden Grove, California (6-1-84):
$ 3,100M - Banks
8,700M - Credit Unions
2,000M - Savings and Loans
469M - Bureau of Indian Affairs
4,200M - Others
$18,469M (50%)

FAIC Securities, FL
Caray Investments, CA
Golconda Financial, CA
First United Fund, Ltd., NY
TCD National, CA
California Investment, CA
International Investments, CA
National Money Market, CA
Connie Tait Financial, CA
Evergreen Investments, Newport Beach, CA
Pacific Money Investment, Inc., WA

(58) Republic Bank of Kansas City, Kansas City, Missouri (6-18-84):
$ 9,476M - Banks
768M - Savings and Loans
2,467M - Credit Unions
1,328M - Bureau of Indian Affairs
3,854M - Others
$17,911M (46%)

FAIC Securities, FL
Harvey Baskin & Co., D.C.
Monetary Investments Co., S.D.

(59) American Bank, Saint Joseph, Tennessee (6-27-84):
$1,700M - Banks & Trust Companies
300M - Credit Unions
100M - Other
$2,100M (7%)

Bradford Trust Co., New York, NY
Standard Investors Trust Co., Houston, TX

(60) Guaranty State Bank of Saint Paul, St. Paul, Minnesota (7-19-84):
$ 657M - Bureau of Indian Affairs
700M - Credit Unions
100M - Savings and Loan
810M - Others
$2,267M (8%)

Commonwealth Capital Corp., VA
First United Fund, Ltd., NY
Independent State Bank of Minnesota, MN

(61) Jackson County National Bank, Tuckerman, Arkansas (8-9-84):
$ 200M - Banks
200M - Savings and Loans
800M - Credit Unions
100M - Other
$1,300M (10%)

First United Fund, Ltd., N.Y.

(62) Girod Trust Company, Puerto Rico (8-16-84):
$37,000M (13%)

Dean Witter, New York, NY
E.F. Hutton, New York, NY
Harvey Baskin & Co., D.C.
Merrill Lynch, New York, NY

(63) The First State Bank, Thayer, Kansas (8-22-84):
$100M - Bank
100M - Savings & Loan
$200M (2%)

First National Bank of Hutchinson, Hutchinson, KS

(64) Bank of Northwest, Eugene, Oregon (8-31-84):
$810M (5%)

Independent State Bank of Minnesota, MN

(65) The Rexford State Bank, Rexford, Kansas (10-10-84):
$1,798M - Credit Unions
200M - Banks
300M - Savings and Loans
100M - Other
$2,398M (45%)

First United Fund, Ltd., N.Y.

(66) State Bank of Boyd, Boyd, Minnesota (10-24-84):
$350M (6%)

Independent State Bank of Minnesota, MN

(67) The Strong City State Bank, Strong City, Kansas (11-29-84):
$98M (2%) - Bank

First Empire Funding Corp., NY

(68) Golden Spike State Bank, Tremonton, Utah (12-4-84):
$ 92M - Bureau of Indian Affairs
300M - Credit Unions
100M - Savings and Loan
300M - Banks
$792M (12%)

Commonwealth Capital Corp., VA
FAIC Securities, FL
First Empire Funding Corp., NY
Golconda Financial, CA

(69) The Farmers State Bank, Seldon, Kansas (12-20-84):
$1,700M - Credit Unions
400M - Banks
800M - Others
$2,900M (21%)

American Money Market Investment Corp., Irvine, CA
First American Investment Group, Topeka, KS
Financial Northeast Corp., West Caldwell, NJ
Investment Transaction Corp., CA

(70) Citizens Fidelity Bank Bristol, Tennessee (2-1-85):
$ 98M - Credit Union
98M - Bank
98M - Municipality
$298M (2%)

First United Fund, Ltd., NY

(71) Peoples Bank and Trust Co., Wartburg, Tennessee (2-8-85):
$1,500M - Credit Unions
4,400M - Savings and Loans
1,800M - Banks
1,700M - Others
$6,400M (32%)

Brittenum and Associates, AR
Caray Investment Company, Inc., CA
First Empire Funding Corp., NY
Golconda Financial, CA

(72) West Valley Bank, Woodland Hills, California (2-8-85):
$ 4,800M - Credit Uninos
5,400M - Savings and Loans
4,300M - Banks
3,100M - Others
$17,600M (53%)

Caray Investment Company, Inc., CA
First Empire Funding Corp., NY
High Yield Management, NJ
Kominz Co., CA
Long Beach Savings and Loan, CA
National Asset Management, NY
National Rate Exchange, San Diego, CA
New Financial Northeast Corp., NJ
Peak Financial
Professional Asset Management, CA
TCD National, Inc., CA

(73) Golden Valley Bank, Turlock, California (3-22-85):
$ 400M - Credit Unions
600M - Savings and Loans
1,100M - Banks
$2,100M (3%)

First Empire Funding, Corp., NY

(74) Fidelity Bank of Denver, Denver, Colorado (3-29-85):
$1,400M - Credit Unions
400M - Savings and Loans
400M - Banks
100M - Municipality
100M - Other
$2,400M (9%)

First Empire Funding Corp., NY
First United Fund, Ltd., NY

(75) Capistrano National Bank, San Juan Capistrano, California (4-5-85):
$ 700M - Credit Unions
900M - Savings and Loans
700M - Banks
200M - Others
$2,500M (6%)

American Money Market Services, Inc., CA
Diversified Financial, Alhambra, CA
First Empire Funding Corp., NY
Pioneer Financial Services, Melville, NY

(76) South Coast Bank, Costa Mesa, California (4-12-85):
$ 900M - Credit Unions
600M - Savings and Loans
200M - Banks
200M - Municipalities
600M - Others
$2,500M (9%)

FAIC Securities, FL
First United Fund, Ltd., N.Y.

(77) The Energy Bank, N.A., Dallas, Texas (5-16-85):
$ 700M - Credit Unions
900M - Savings and Loans
700M - Banks
500M - Others
$2,800M (12%)

First United Fund, Ltd., NY
Meyers Pollack Robbins, Inc., New York, NY
The Kominz Company, CA

(78) Strong's Bank, Dodgeville, Wisconsin (6-14-85):
$ 900M - Credit Unions
100M - Savings and Loan
100M - Bank
$1,100M (4%)

All are believed to have originated through High Yield Management, Inc., Clifton, NJ. Substantial amounts of other brokered funds were apparently diverted and not entered on books.

(79) First City Bank, N.A., Oklahoma City, Oklahoma (6-21-85):
$5,700M (7%)

First Empire Funding Corp., NY
FAIC Securities, FL
Caray Investment Co., Inc., CA
James Baker and Company, Oklahoma City, OK

(80) Crossroad State Bank, Oklahoma City, Oklahoma (7-11-85):
$3,500M (21%)

Brokers and financial institutions supplying funds unavailable at this time

SCHEDULE B

Case Studies of Selected Failed Banks Using Brokered Funds

1. Peoples Bank & Trust Company, Wartburg, Tennessee

Bank was closed on February 8, 1985. At that time brokered deposits totaled $6,400,000 and represented 32% of total deposits of $20,058,000. In July of 1984 ownership and control of the bank changed and immediately thereafter brokered deposits were introduced into the bank, reaching a high of $7,100,000 by the end of August, 1984. Brokered deposits provided the major share of the funding for the bank's acquisition of over $11 million in out-of-territory timeshare and solar-energy contracts from a corporate interest of the new control owners in an elaborate link-financing scheme, which resulted in losses approaching $10 million.

2. Strong's Bank, Dodgeville, Wisconsin

Bank was closed on June 14, 1985. At that time brokered deposits totaled $1,100,000 and represented 4% of total deposits of $30,200,000. Bank was in weakened condition in early 1985 due to loan losses and under pressure from the FDIC to increase capital and improve asset condition. In May of 1985 brokered deposits were introduced into the bank in a fraudulent link-financing scheme designed to give the appearance of recapitalizing the bank and replacing poor-quality loans on the bank's books with new loans of supposedly satisfactory quality. Substantial additional brokered funds were apparently diverted and never recorded on the bank's books.

Schedule B
Page 2

3. Indian Springs State Bank, Kansas City, Kansas

Bank was closed January 27, 1984. At that time brokered deposits totaled $9,300,000 and represented 34% of total deposits of $27,074,000 on the date of closing. These deposits provided the funding for a link-financing scheme involving out-of-territory real estate development loans which resulted in enormous losses, rendering the bank insolvent.

4. West Valley Bank, Woodland Hills, California

Bank closed February 8, 1985. At that time brokered deposits totaled $17,600,000 and represented 53% of total deposits of $33,100,000. Brokered deposits were first introduced into the bank in the second quarter of 1984 and reached a high of $17,600,000 as of the date of closing. These funds provided funding for the acquisition of over $6,200,000 in fraudulent insurance premium financing contracts, which resulted in the bank's failure.

5. Community Bank, Hartford, South Dakota

Bank was closed June 17, 1983. At the time of closing, brokered funds totaled $10,400,000 and represented 27% of total deposits of $39,073,000. Brokered deposits were introduced into the bank in April 1983 and reached a high of $10,400,000 as of the date of closing. These funds provided funding for the purchase of a $10,400,000 annuity from an obscure North Dakota insurance company. The annuity was subsequently determined to be worthless, thus eliminating the bank's capital accounts. The bank was persuaded to enter into this transaction by an individual who had promised to purchase the bank at a price well in excess of its market value.

6. Farmers State Bank, Selden, Kansas

Bank was closed December 20, 1984. At the time of closing brokered deposits totaled $2,900,000 and represented 21% of the bank's total deposits of $13,758,000. Brokered deposits were first introduced in the bank in December, 1983 and reached a high of $3,200,000 in November, 1984. These monies were used to fund bogus loans, causing the bank's failure.

SCHEDULE C

THE 25 LARGEST SUPPLIERS OF FULLY INSURED BROKERED DEPOSITS TO TROUBLED, FDIC-INSURED BANKS AND THRIFTS

*(Based upon available survey data as of February 28, 1985)

1.	Merrill Lynch	$771,268,000
2.	Dean Witter Reynolds Inc.	447,000,000
3.	Prudential Bache Securities, Inc.	131,406,000
4.	The First Boston Company	115,500,000
5.	Goldman Sachs & Company	80,000,000
6.	Professional Asset Securities, Del Mar, California	63,979,000
7.	FAIC Securities, Inc., Miami, Florida	44,395,000
8.	First Empire Funding Corp., Huntington, N.Y.	43,564,000
9.	The Calvert Group	41,665,000
10.	A.G. Becker	38,000,000
11.	Golconda Financial, South El Monte, California	31,650,000
12.	Shearson Lehman/American Express	28,700.000
13.	First United Fund LTD, Garden City, N.Y.	28,100,000
14.	Paine Webber	27,003,000
15.	Salomon Brothers	26,000,000
16.	Jessup Group, Westport, Connecticut	26,000,000
17.	MKI Money Markets, Inc., N.Y., N.Y.	20,000,000
18.	Harvey Baskin (CDX), Washington, D.C.	19,593,000
19.	Long Beach Savings & Loan Association, Long Beach, California	14,555,000
20.	TCD National, Inc., Encino, California	14,500,000
21.	Churchill, Burbank, California	14,300,000
22.	Continental Money Markets, Inc., San Mateo, California	12,248,000
23.	Morgan Stanley International	10,000,000
24.	Garvin Guy Butler Corporation, San Francisco, California	10,000,000
25.	TCS Funds Brokerage	9,298,000

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* The survey was limited to troubled institutions holding 5% or more of their deposits in fully insured brokered funds and excluded direct placements by other insured banks, thrifts and credit unions.

Chairman **Hubbard**. Thank you very much, Bill Isaac.

Before we ask you questions, however, Mr. Isaac, we would like to hear the testimony of the Honorable Joe Selby, Acting Comptroller of the Currency for our Federal Government.

Welcome to the subcommittee, Joe Selby. We will hear your comments now and receive your testimony.

STATEMENT OF HON. H. JOE SELBY, ACTING COMPTROLLER OF THE CURRENCY

Mr. **Selby**. Thank you, Mr. Chairman.

If I could make my whole statement a part of the record, I will just summarize it now.

Chairman **Hubbard**. Without objection, that is ordered.

Mr. **Selby**. Since my Congressman, Mr. Gonzalez, is not here to claim his native son, I will have to claim being a resident of Virginia for the last 10 years, Congressman Parris.

Mr. **Parris**. I congratulate you on your judgment.

Mr. **Selby**. Mr. Chairman, members of the subcommittee, I appreciate the opportunity to comment on the use of brokered deposits by national banks and the appropriate way to address the problems that brokered deposits pose to the Federal deposit insurance system and to the national banking system.

Deposit brokerage provides important benefits to savers, depository institutions, and the economy as a whole. Consumers can buy certificates of deposit [CD's] issued by banks or thrift institutions anywhere in the country through a deposit broker. Therefore, through deposit brokers, individual savers can conveniently shop for the interest rate, denomination, and maturity that they want.

Deposit brokering can be an efficient means for banks and thrift institutions to attract deposits. Brokered deposits represent an inexpensive means to attract deposits. For most institutions, deposit brokerage provides more flexibility in matching assets and liabilities than is possible with funds acquired through a branch system. It makes it easier for institutions to acquire long-term deposits and gives small institutions access to regional and national markets. Finally, deposit brokerage facilitates the flow of funds from communities that have a capital surplus to other markets where funds are scarce.

The use of brokered deposits within the national banking system is far from pervasive. As of March 31, 1985, national banks held over $1.1 trillion in deposits. Less than 1½ percent of all deposits, or $16.2 billion, were reported to have been placed by brokers. Of those brokered funds, two-thirds were wholesale brokered deposits—large, uninsured CD's placed by established brokers for institutional investors. Thus, retail brokered deposits—those that are fully insured by the FDIC—amounted to less than one-half of 1 percent of the total deposits in national banks.

Furthermore, of the 4,925 national banks, only 270 banks, or 6 percent, reported any brokered deposits in the March 31, 1985 Call Report. Of those national banks reporting brokered funds, 183, or two-thirds, had brokered deposits amounting to less than 5 percent of total deposits. Close to 90 percent of the banks had brokered deposits amounting to less than 10 percent of total deposits. These figures include wholesale brokered deposits, which amount to two-thirds of all brokered deposits.

The vast majority of the national banks with brokered deposits are sound, well-run institutions. Of the national banks currently on our problem bank list, 15 percent have brokered deposits. National banks on the problem bank list that are using brokered deposits are receiving close supervision and monitoring. Where appropriate, we have restricted, barred or otherwise curtailed their use of brokered funds.

While the benefits of deposit brokering are substantial, there are clearly legitimate concerns regarding the placement by brokers of large deposits into fully insured accounts at several banks. First, this activity can hasten the deterioration of a distressed or poorly managed institution. Second, it minimizes market discipline while increasing the exposure of the insurance funds.

The ability of a bank to obtain insured funds quickly can, in some cases, present serious supervisory problems. The use of brokered funds can enable a bank to undergo sudden, rapid growth. Whether this is a problem, of course, depends not on the fact that the funds came from deposit brokers but on how the funds are put to use. If a bank is imprudently managed, sudden growth may reflect increased risk.

Although these supervisory problems are not insignificant, the Office has adequate authority to deal with them. First, we routinely look at the use of brokered deposits as part of our normal bank examinations. Also, we have issued a series of examining issuances giving instructions on the monitoring of brokered deposits, which I would like to enter into the record.

Chairman HUBBARD. Without objection, so ordered.

[The material submitted by Mr. Selby for inclusion in the record maybe found beginning on page 287.]

Mr. SELBY. Banks are also subject to minimum capital standards that limit the ability of a bank to undergo rapid growth, thereby indirectly restricting the imprudent use of brokered deposits.

In addition, we have begun exercising a wide range of restrictions and limitations on brokered deposits that are applied on a case-by-case basis.

These procedures have been quite effective in most cases. Of the 14 national banks that had failed in 1985 as of June 30, only 3 had reported using brokered deposits. In 1984, two of these banks were directed by this Office to eliminate their use of insured brokered deposits. As a result, insured brokered deposits at one bank fell from 11 percent of total deposits in the third quarter of 1984 to zero by year end 1984. At the second bank, insured brokered deposits fell from 28 percent to 13 percent over the same time period. The third bank was directed in early 1985 to cease its use of brokered deposits. By the time of insolvency in June 1985, its brokered deposits had fallen from 3 percent of deposits to 2 percent of deposits.

The supervisory issues raised by deposit brokering are not unique and, I think, can be dealt with by the agencies under their existing regulatory authority. However, the increased use of brokered funds to provide full insurance coverage for large deposits raises two other problems.

First, the exposure of the Federal deposit insurance fund is increased. This is particularly true when these fully insured brokered funds flow to institutions in a weakened financial condition that are advertising and paying higher interest rates.

Second, when large depositors can obtain full insurance coverage through deposit brokerage, the banks issuing the CD's are not subjected to the market discipline that might otherwise be provided by such large depositors.

We would recommend three steps to enhance market discipline of banks and reduce the occurrence of deposit brokering that is motivated soley by the desire to obtain full deposit insurance on large deposits.

First, we would propose limiting the insurance coverage of a depositor on funds placed through any single broker to $100,000.

Second, Congress should enact much-needed reform of the deposit insurance system itself, including empowering the FDIC and the FHLBB to develop a mechanism to assure that uninsured depositors experience some degree of loss in Government-assisted mergers and authorizing the FDIC and FHLBB to develop a risk-related premium structure.

This office supports increased public disclosure of, and common standards for disclosing information on the financial conditions of banks and thrift institutions. We have developed a proposal on doing just that.

Together, these changes would enlist the discipline of large depositors to supplement that provided by the regulators. Depositors would still be able to use deposit brokers to diversify their risk. Small depositors would not be affected by these changes and could still obtain insured deposits. The changes would mean that those reaping the rewards of high interest rates would also bear the risks, instead of having the risk of failure shifted to the insurance fund. The result would be that market discipline would play a more fundamental role in assuring the safety and soundness of the banking system. Thank you.

[The prepared statement of Mr. Selby follows:]

Statement of

H. Joe Selby

Acting Comptroller of the Currency

before the

Subcommittee on General Oversight and Investigations

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

July 16, 1985

Mr. Chairman, members of the Subcommittee, I appreciate the opportunity to comment on the use of brokered deposits by national banks and the appropriate way to address the problems that brokered deposits pose to the federal deposit insurance system and to the national banking system. These views are my own and not necessarily those of the Administration.

Deposit brokering performs a valuable economic function for depositors and financial institutions. However, brokered deposits also raise certain supervisory concerns as well as questions about the incentives currently built into our federal deposit insurance system. This Office is taking steps to alleviate the supervisory problems presented by deposit brokering. In addition, we have three recommendations to address the problems that brokered deposits pose to the federal deposit insurance system.

THE USE OF BROKERED DEPOSITS

Deposit brokerage provides important benefits to savers, depository institutions, and the economy as a whole. Consumers can buy certificates of deposit (CDs) issued by banks or thrift institutions anywhere in the country through a deposit broker. Therefore, through deposit brokers, individual savers can conveniently shop for the interest rate, denomination, and maturity that they want. Moreover, many deposit brokers provide an additional source of liquidity by making a secondary market in CDs. In these cases, small savers can sell their CDs back to their brokers without paying early withdrawal penalties, while banks continue to have the use of long-term funds. It is a situation where both the consumer and depository institution win.

Deposit brokering can be an efficient means for banks and thrift institutions to attract deposits. Brokered deposits represent an inexpensive means to attract deposits. For most institutions, deposit brokerage provides more flexibility in matching assets and liabilities than is possible with funds acquired through a branch system. It makes it easier for institutions to acquire long-term deposits and gives small institutions access to regional and national markets. Finally, deposit brokerage facilitates the flow of funds from communities that have a capital surplus to other markets where funds are scarce.

Brokered Deposits in National Banks

The use of brokered deposits within the national banking system is far from pervasive. As of March 31, 1985, national banks held over $1.1 trillion dollars in deposits. Less than 1-1/2 percent of all deposits, or $16.2 billion, were reported to have been placed by brokers. Of those brokered funds, two-thirds were large, uninsured CDs placed by established brokers for institutional investors ("wholesale brokered deposits"). Thus "retail brokered deposits" -- those that are fully insured by the FDIC -- amounted to less than 1/2 of 1 percent of the total deposits in national banks.

Furthermore, of the 4,925 national banks, only 270 banks, or 6 percent, reported any brokered deposits in the March 31, 1985 Call Report. Of those national banks reporting brokered funds, 183, or two-thirds, had brokered deposits amounting to less than 5 percent of total deposits. Close to 90 percent had brokered deposits amounting to less than 10 percent of total deposits. These figures include wholesale brokered deposits, which amount to two-thirds of all brokered deposits.

The vast majority of the national banks with brokered deposits are sound, well-run institutions. Of the national banks currently on our problem bank list, 15 percent have brokered deposits. National banks on the problem bank list that are using brokered deposits are receiving close supervision and monitoring. Where appropriate, we have restricted, barred, or otherwise curtailed their use of brokered funds.

PROBLEMS RAISED BY BROKERED DEPOSITS

While the benefits of deposit brokering are substantial, there are clearly legitimate concerns regarding the placement by brokers of large deposits into fully insured accounts at several banks. First, this activity can hasten the deterioration of a distressed or poorly managed institution. Second, it minimizes market discipline while increasing the exposure of the insurance funds.

Supervisory Concerns

The ability of a bank to obtain insured funds quickly can, in some cases, present serious supervisory problems. For example, when a bank experiencing liquidity problems can turn to brokered funds rather than borrow from its Federal Reserve Bank, supervisory detection of problems is hampered. Moreover, the use of brokered funds can enable a bank to undergo sudden, rapid growth. Whether this is a problem, of course, depends not on the fact that the funds came from deposit brokers but on how the funds are put to use. If a bank is imprudently managed, sudden growth may reflect increased risk. In short, one negative effect of brokered funds is to enable small problem banks to quickly become larger problem banks.

Although these supervisory problems are not insignificant, the Office has adequate authority to deal with them. First, we routinely look at the use of brokered deposits as part of our normal bank examinations. Banks are also subject to minimum capital standards that limit the ability of a bank to undergo rapid growth, thereby indirectly restricting the imprudent use of brokered deposits.

In cooperation with the other banking agencies, we recently added new reporting requirements to the quarterly Call Report. Starting in 1983, banks have been required to report brokered deposits as a separate item. Beginning with the March 31, 1984 report, banks began breaking out retail brokered deposits. We use this information to monitor brokered deposit activity in the system as a whole and in individual banks.

In addition, we have procedures in place to make sure that brokered deposits are not used to turn small problem banks into big problem banks overnight. More specifically, this Office has begun exercising a wide range of restrictions and limitations on brokered deposits that are applied on a case-by-case basis. They range from a simple requirement to report the use of brokered deposits to a total prohibition on brokered deposit use. The severity of the restriction depends on the type and magnitude of problems in individual banks. We are including one or more of these limitations in enforcement agreements with problem banks where brokered funds are now a problem or where we believe that use of brokered funds may exacerbate existing problems.

These procedures have been quite effective in most cases. Of the 14 national banks that had failed in 1985 as of June 30, only three had reported using brokered deposits. In 1984, two of these banks were directed by this Office to eliminate their use of insured brokered deposits. As a result, insured brokered deposits at one bank fell from 11 percent of deposits in the third quarter of 1984 to zero by year-end 1984. At the second bank, insured brokered deposits fell from 28 percent to 13 percent over the same time period. The third bank was directed in early 1985 to cease its use of brokered deposits. By the time of insolvency in June 1985, its brokered deposits had fallen from 3 percent of deposits to 2 percent of deposits.

FDIC Liability and Market Discipline

The supervisory issues raised by deposit brokering are not unique and can be dealt with by the agencies under their existing regulatory authority. However, the increased use of brokered funds to provide full insurance coverage for large deposits raises two other problems.

First, the exposure of the federal deposit insurance fund is increased. This is particularly true when these fully insured brokered funds flow to institutions in a weakened financial condition that are paying higher interest rates.

Second, when large depositors can obtain full insurance coverage through deposit brokerage, the banks issuing the CDs are not subjected to the market discipline that might otherwise be provided by such large depositors. When depositors can place funds with institutions solely on the basis of yield without regard to the riskiness of the institutions, bank managers escape the scrutiny of the marketplace. This puts an increased burden on the regulators to limit risk-taking by banks and hinders the achievement of an important public policy goal: increased market discipline.

ALTERNATIVE SOLUTIONS

Many proposals have been put forth to address the problems raised by the brokerage of insured retail deposits. The approach of most of them is to place various limitations on institutions' use of brokered funds. In our view, this approach only addresses a symptom, while ignoring the more fundamental cause of the problem: the structure of our deposit insurance system.

As I stated earlier, this Office currently has the ability to deal with any abuses or risks arising from problem banks' use of brokered deposits. However, we do feel that reforms are needed to deal with the reduced market discipline and concomitant heightened exposure of the insurance funds that are brought about by large depositors splitting their funds into fully-insured increments. We recommend three steps to enhance market discipline of banks and reduce the occurrence of deposit brokering that is motivated solely by the desire to obtain full deposit insurance on large deposits.

First, we propose limiting the insurance coverage of a depositor on funds placed through any single broker to $100,000. That would preserve the benefits of deposit brokerage to small savers while making it impossible for large and presumably more sophisticated investors to use brokers to split their funds into insured lots. It would also allow depository institutions to continue to use brokers to gather small retail deposits.

Second, Congress should enact much-needed reform of the deposit insurance system itself. There are a number of possibilities that could be considered. The FDIC and the FHLBB might be empowered to develop a mechanism to make certain that uninsured depositors experience some degree of loss in government-assisted mergers. The FDIC and the FHLBB should be authorized to develop a risk-related premium structure for depository institutions. Such an action would reduce the incentive for depository institutions to engage in risky or unsound business practices. Both these changes would help ensure the long-term viability of the deposit insurance system.

Finally, this Office supports increased public disclosure of, and common standards for disclosing, information on the financial condition of banks and thrift institutions. We are currently preparing a proposed rule that will require such increased disclosure. Greater disclosure would permit depositors to better assess the risk involved in depositing funds in a given bank or thrift. Until depositors have enough information to differentiate between well-run and poorly-managed institutions, we cannot expect market discipline to help solve this problem.

Together, these changes would enlist the discipline of large depositors to supplement that provided by the regulators. Depositors would still be able to use deposit brokers to diversify their risk. Small depositors would not be affected by these changes, and could still obtain insured deposits either directly or through a broker. Finally, these changes would mean that those who reap the rewards of high interest rates would also bear the risks, instead of having the risk of failure shifted to the insurance fund. The result would be that market discipline would play a more fundamental role in assuring the safety and soundness of the banking system.

* * * * *

Mr. Chairman, thank you again for this opportunity to appear. I will be pleased to respond to any questions you or members of the Subcommittee may have.

Chairman **Hubbard**. Thank you very much.

This question to Mr. Isaac. Our subcommittee appreciates your providing a list of FDIC insured institutions which failed from January 1, 1982, through July 12 of this year. We would like to request, if you will, that you additionally provide us the most complete and up-to-date list of all failed banks since January 1, 1982, until the present with a breakdown of total assets, total deposits, total brokered deposits, and other information you may feel is pertinent to our inquiry.

Could you do that?

Mr. **Isaac**. Sure.

[In response to the request of Chairman Hubbard, the following information was submitted for the record by Chairman Isaac:]

INSURED BANK FAILURES (January 1, 1982 - October 11, 1985)

1982

Name and location	Date of Closing or Deposit Assumption	Total Assets (000's)	Total Deposits (000's)	Brokered Deposits & Bureau of Indian Affairs (000's)
DEPOSIT PAYOFF				
The Bank of Woodson Woodson, Texas	March 1, 1982	3,168	3,440	
Carroll County Bank Huntingdon, Tennessee	April 30, 1982	8,236	8,108	
Citizens Bank Tillar, Arkansas	June 23, 1982	6,723	6,264	522
Penn Square Bank, N.A. Oklahoma City, Oklahoma	July 5, 1982	516,799	470,446	124,675
Hohenwald National Bank Hohenwald, Tennessee	September 3, 1982	30,380	26,919	200
Tri-State Bank Markham, Illinois	October 8, 1982	16,281	16,034	600
Ranchlander National Bank Melvin, Texas	November 19, 1982	3,831	3,645	
DEPOSIT ASSUMPTIONS AND FINANCIALLY ASSISTED MERGERS				
Western New York Savings Bank Buffalo, New York	January 15, 1982	1,021,964	890,160	
The First National Bank and Trust Company of Tuscola Tuscola, Illinois	February 6, 1982	18,458	15,207	
Metropolitan Bank and Trust Company Tampa, Florida	February 12, 1982	261,415	171,661	13,515
Farmers and Mechanics Savings Bank of Minneapolis Minneapolis, Minnesota	February 20, 1982	980,361	789,388	
Bank of Yorkville Yorkville, Tennessee	February 20,1982	6,557	6,621	
Fidelity Mutual Savings Bank Spokane, Washington	March 11, 1982	689,057	550,486	
United States Savings Bank of Newark, New Jersey Newark, New Jersey	March 11, 1982	674,726	578,366	
The New York Bank for Savings New York, New York	March 26, 1982	3,402,959	2,779,664	
Western Saving Fund Society of Philadelphia Haverford, Pennsylvania	April 2, 1982	2,112,801	1,956,772	
The First National Bank in Humboldbt Humboldbt, Iowa	April 2, 1982	54,410	48,666	
Aquia Bank and Trust Company Stafford, Virginia	April 3, 1982	13,597	13,744	3,636

INSURED BANK FAILURES (January 1, 1982 - October 11, 1985)
(Continued)

Name and location	Date of Closing or Deposit Assumption	Total Assets (000's)	Total Deposits (000's)	Brokered Deposits & Bureau of Indian Affairs (000's)
National Security Bank Tyler, Texas	April 16, 1982	9,293	8,959	300
Pacific Coast Bank San Diego, California	April 29, 1982	10,997	10,064	4,400
Coles County National Bank of Charleston Charleston, Illinois	May 1, 1982	22,813	18,569	
Community Bank of Washtenaw Ypsilanti, Michigan	May 15, 1982	19,642	16,769	
Banco Regional Bayamon, Puerto Rico	June 12, 1982	18,861	15,123	
Farmers State Bank of Lewistown Lewistown, Illinois	June 25, 1982	28,849	27,291	
The Belle-Bland Bank Bland, Missouri	July 2, 1982	4,272	3,934	
The Bowie County State Bank Hooks, Texas	July 27, 1982	14,629	13,663	
Guaranty Bond State Bank Redwater, Texas	July 27, 1982	14,794	12,901	
Unity Bank and Trust Company Boston, Massachusetts	July 30, 1982	11,245	10,488	
Mount Pleasant Bank and Trust Company Mount Pleasant, Iowa	August 6, 1982	28,322	25,777	
Abilene National Bank Abilene, Texas	August 6, 1982	446,042	310,105	
First Security Bank of North Arkansas Horseshoe Bend, Arkansas	August 27, 1982	13,375	11,875	
Security Bank and Trust Company Cairo, Illinois	August 27, 1982	11,706	11,015	
Western National Bank Santa Ana, California	August 27, 1982	22,699	20,682	8,300
United Mutual Savings Bank New York, New York	September 24, 1982	832,858	777,890	
Oklahoma National Bank and Trust Company Oklahoma City, Oklahoma	October 3, 1982	149,949	135,586	
Mechanics Savings Bank Elmira, New York	October 15, 1982	55,254	50,608	
Cedar Bluff Bank Cedar Bluff, Alabama	November 2, 1982	14,002	13,053	
The First National Bank of South Charleston South Charleston, West Virginia	November 5, 1982	26,811	26,935	
Texas Bank of Amarillo Amarillo, Texas	November 5, 1982	10,549	9,188	

INSURED BANK FAILURES (January 1, 1982 - October 11, 1985)
(Continued)

Name and location	Date of Closing or Deposit Assumption	Total Assets (000's)	Total Deposits (000's)	Brokered Deposits & Bureau of Indian Affairs (000's)
Bank of Quitman Quitman, Arkansas	November 12, 1982	17,565	16,798	
Bollinger County Bank Lutesville, Missouri	December 10, 1982	15,309	14,536	
The Security State Bank Mooreland, Oklahoma	December 16, 1982	10,855	9,917	
	1983			
DEPOSIT PAYOFF				
State Bank of Barnum Barnum, Minnesota	February 9, 1983	13,288	12,611	5,500
Columbia Pacific Bank and Trust Company Portland, Oregon	March 18, 1983	35,804	31,644	
Prairie County Bank Hazen, Arkansas	March 24, 1983	16,455	15,479	
Sparta-Sanders State Bank Sparta, Kentucky	April 15, 1983	19,585	18,303	12,443
Western National Bank of # of Lovell Lovell, Wyoming	June 24, 1983	13,312	17,416	12,600
Mineral Bank of Nevada Las Vegas, Nevada	June 30, 1983	10,037	10,525	4,550
Union National Bank of Chicago Chicago, Illinois	July 8, 1983	23,908	24,518	
First National Bank of Browning Browning, Montana	November 10, 1983	11,289	11,602	4,000
Atkinson Trust and Savings Bank Atkinson, Illinois	November 25, 1983	20,359	18,900	3,356
DEPOSIT ASSUMPTIONS, LOANS AND FINANCIALLY ASSISTED MERGERS				
The Madison County Bank Fredericktown, Missouri	January 21, 1983	6,701	6,555	
Dry Dock Savings Bank New York, New York	February 9, 1983	2,500,000	2,037,959	
American State Bank Bradley, Illinois	February 12, 1983	12,115	12,463	
United American Bank in Knoxville Knoxville, Tennessee	February 14, 1983	778,434	584,619	
Merchants and Farmers State Bank Blythe, California	February 18, 1983	5,319	5,204	
American City Bank Los Angeles, California	February 25, 1983	271,765	254,536	82,150

INSURED BANK FAILURES (January 1, 1982 - October 11, 1985)
(Continued)

Name and location	Date of Closing or Deposit Assumption	Total Assets (000's)	Total Deposits (000's)	Brokered Deposits & Bureau of Indian Affairs (000's)
Newport Harbour National Bank Newport Beach, California	March 11, 1983	47,663	44,234	33,956
Pan American National Bank Union City, New Jersey	March 18, 1983	30,830	31,275	7,006
Bear Creek Valley Bank Phoenix, Oregon	March 25, 1983	11,019	10,855	5,945
The Ina State Bank Ina, Illinois	April 8, 1983	16,253	15,892	
Bank of San Marino San Marino, California	April 8, 1983	12,959	12,707	2,900
Heritage Bank Ashland, Oregon	April 29, 1983	16,408	14,621	600
First National Bank of Oak Lawn Oak Lawn, Illinois	April 29, 1983	120,081	119,448	
Smith County Bank Carthage, Tennessee	May 6, 1983	28,231	27,198	
City and County Bank of Knox County Knoxville, Tennessee	May 27, 1983	243,885	227,481	86,730
United Southern Bank of Nashville Nashville, Tennessee	May 27, 1983	114,835	96,300	35,955
United American Bank in Hamilton County Chattanooga, Tennessee	May 27, 1983	134,653	105,993	10,100
City and County Bank of Roane County Kingston, Tennessee	May 27, 1983	40,120	36,499	1,280
City and County Bank of Anderson County Lake City, Tennessee	May 27, 1983	142,000	139,561	19,980
The Commercial Bank of California Los Angeles, California	May 27, 1983	27,772	23,057	6,300
Community Bank Hartford, South Dakota	June 17, 1983	42,383	39,327	10,400
The First Central Bank Smithville, Tennessee	July 8, 1983	18,989	18,246	600
Bank of Niobrara Niobrara, Nebraska	July 8, 1983	7,285	6,239	
First Peoples Bank of Washington County Johnson City, Tennessee	July 29, 1983	152,543	176,549	56,288
Metro Bank Midland, Texas	July 29, 1983	30,747	28,786	
Oregon Mutual Savings Bank Portland, Oregon	August 5, 1983	260,000	251,337	

INSURED BANK FAILURES (January 1, 1982 - October 11, 1985)
(Continued)

Name and location	Date of Closing or Deposit Assumption	Total Assets (000's)	Total Deposits (000's)	Brokered Deposits & Bureau of Indian Affairs (000's)
The First National Bank of Danvers Danvers, Illinois	August 5, 1983	10,557	10,843	
First Commerce Bank of Hawkins County Rogersville, Tennessee	August 12, 1983	47,213	43,734	6,580
United Southern Bank of Clarksville Clarksville, Tennessee	August 26, 1983	8,730	10,394	3,556
The Douglas State Bank Kansas City, Kansas	September 2, 1983	28,327	26,545	2,500
Warren County Bank McMinnville, Tennessee	September 16, 1983	19,310	18,801	4,583
Dominion Bank of Denver Denver, Colorado	September 30, 1983	11,461	11,915	5,762
National Bank of Odessa Odessa, Texas	September 30, 1983	77,662	76,164	2,500
Auburn Savings Bank Auburn, New York	October 1, 1983	130,000	131,382	
The Deschutes Bank Redmond, Oregon	October 7, 1983	9,414	9,224	1,400
The First National Bank of Midland Midland, Texas	October 14, 1983	1,404,092	574,183	75,672
Union Trust Company San Juan, Puerto Rico	December 9, 1983	25,630	23,275	
Bank of Hackleburg Hackleburg, Alabama	December 13, 1983	6,833	6,800	
The Bank of Red Oak Red Oak, Oklahoma	December 16, 1983	10,667	10,408	
		1984		
DEPOSIT PAYOFF				
Heritage Bank Anaheim, California	March 16, 1984	157,970	155,444	98,388
West Coast Bank Los Angeles, California	April 27, 1984	190,183	155,849	84,111
Stewardship Bank of Oregon Portland, Oregon	June 8, 1984	5,232	5,565	
Hereford State Bank Hereford, Colorado	August 24, 1984	2,666	2,444	
DEPOSIT TRANSFERS TO OPERATING BANKS				
Indian Springs State Bank Kansas City, Kansas	January 27, 1984	26,846	25,460	9,300
Seminole State National Bank Seminole, Texas	March 16, 1984	47,432	46,428	300

INSURED BANK FAILURES (January 1, 1982 - October 11, 1985)
(Continued)

Name and location	Date of Closing or Deposit Assumption	Total Assets (000's)	Total Deposits (000's)	Brokered Deposits & Bureau of Indian Affairs (000's)
Security National Bank of Lubbock Lubbock, Texas	April 13, 1984	46,110	45,292	3,397
Gamaliel Bank Gamaliel, Kentucky	April 19, 1984	22,588	21,657	
United America Bank Chicago, Illinois	April 26, 1984	33,398	34,173	300
First National Bank Snyder, Texas	May 4, 1984	15,844	14,712	
The National Bank of Camel Carmel-by-the-Sea, California	May 8, 1984	76,118	73,919	29,430
First Contiental Bank & Trust Company of Del City Del City, Oklahoma	May 11, 1984	103,347	92,930	21,519
Republic Bank of Kansas City Kansas City, Missouri	June 18, 1984	40,535	30,201	17,911
American Bank Saint Joseph, Tennessee	June 27, 1984	34,445	30,692	2,100
The Dayton Bank & Trust Company Dayton, Tennessee	November 30, 1984	48,632	46,120	
Uehling State Bank Uehling, Nebraska	December 18, 1984	4,222	3,711	
DEPOSIT ASSUMPTIONS, LOANS, AND FINANCIALLY ASSISTED MERGERS				
Farmers Bank & Trust Winchester, Tennessee	January 6, 1984	46,457	46,990	
City and County Bank of Jefferson County White Pine, Tennessee	January 20, 1984	20,888	22,025	580
Emerald Empire Banking Company Springfield, Oregon	February 3, 1984	19,595	19,825	11,000
The Tucker County Bank Parsons, West Virginia	February 3, 1984	16,171	15,480	3,557
Heritage Bank of Bureau County Depue, Illinois	February 8, 1984	8,467	7,865	
West Olympia Bank Los Angeles, California	February 10, 1984	20,663	19,741	
Brownfield State Bank and Trust Company Brownfield, Texas	February 17, 1984	34,451	36,582	
United Bank of Oregon Milwaukie, Oregon	March 2, 1984	14,699	14,350	1,550
All American National Bank of Virginia Gardens Miami, Florida	March 2, 1984	12,942	11,062	2,000

INSURED BANK FAILURES (January 1, 1982 - October 11, 1985)
(Continued)

Name and location	Date of Closing or Deposit Assumption	Total Assets (000's)	Total Deposits (000's)	Brokered Deposits & Bureau of Indian Affairs (000's)
National Bank and Trust Company of Traverse City Traverse City, Michigan	March 9, 1984	74,228	68,210	
First Security Bank Erwin, Tennessee	April 6, 1984	24,004	21,777	2,996
Watauga Valley Bank Elizabethton, Tennessee	April 6, 1984	12,545	13,256	1,888
The Shelby National Bank of Shelbyville Shelbyville, Indiana	April 19, 1984	66,936	61,041	
Citizens Bank of Monroe County Tellico Plains, Tennessee	April 27, 1984	20,029	20,108	
Western National Bank of Casper Casper, Wyoming	May 4, 1984	21,450	22,626	
State Bank of Mills Mills, Wyoming	May 4, 1984	5,601	6,123	
The First National Bank of Rushford Rushford, Minnesota	May 4, 1984	21,799	20,382	360
The Mississippi Bank Jackson, Mississippi	May 11, 1984	227,163	152,983	
Bledsoe County Bank Pikeville, Tennessee	May 18, 1984	4,814	4,796	
Planters Trust & Savings Bank of Opelousas Opelousas, Louisiana	May 18, 1984	64,012	56,223	
Bank of Irvine Irvine, California	May 18, 1984	27,445	24,623	1,400
Washington National Bank of Chicago Chicago, Illinois	May 18, 1984	13,373	13,352	
First National Bank of Prior Lake Prior Lake, Minnesota	May 24, 1984	14,248	13,460	2,500
Garden Grove Community Bank Garden Grove, California	June 1, 1984	39,398	34,062	18,479
Cherokee County Bank Centre, Alabama	June 5, 1984	38,365	36,803	
Farmers State Bank Lyons, South Dakota	June 15, 1984	3,017	2,846	
The Lawrence County Bank Lawrenceburg, Tennessee	June 15, 1984	24,093	23,400	
The Corning Bank Corning, Arkansas	June 15, 1984	34,079	31,158	
The Farmers National Bank Of Aurelia Aurelia, Iowa	June 21, 1984	18,899	18,316	

INSURED BANK FAILURES (January 1, 1982 - October 11, 1985)
(Continued)

Name and location	Date of Closing or Deposit Assumption	Total Assets (000's)	Total Deposits (000's)	Brokered Deposits & Bureau of Indian Affairs (000's)
East Texas Bank and Trust Company Longview, Texas	June 29, 1984	90,059	77,302	
The Coffeen National Bank Coffeen, Illinois	July 12, 1984	9,372	9,571	
The Guaranty Bank of Saint Paul St. Paul, Minnesota	July 19, 1984	25,718	24,744	2,267
Coalmont Savings Bank Coalmont, Tennessee	July 24, 1984	24,439	22,947	
Jackson County National Bank Tuckerman, Arkansas	August 9, 1984	13,318	12,985	1,300
Peoples State Bank of Clay County Poland, Indiana	August 10, 1984	11,840	12,228	
The Tingley State Savings Bank Mount Ayr, Iowa	August 10, 1984	18,805	17,970	
American National Bank in McLean McLean, Texas	August 16, 184	14,098	13,159	
Girod Trust Company San Juan, Puerto Rico	August 16, 1984	398,666	263,144	37,000
The First State Bank Thayer, Kansas	August 22, 1984	12,025	11,085	200
Bank of the Northwest Eugene, Oregon	August 31, 1984	19,212	15,384	810
David City Bank David City, Nebraska	September 6, 1984	21,185	17,611	
Oakland Savings Bank Oakland, Iowa	September 7, 1984	21,048	19,483	
Community Bank & Trust Company Enid, Oklahoma	September 14, 1984	28,528	22,846	
Bank of Verdigre & Trust Company Verdigre, Nebraska	September 19, 1984	12,957	12,587	
Century National Bank Jacksonville, Florida	September 20, 1984	15,176	15,220	
Security State Bank Weatherford, Oklahoma	September 21, 1984	52,236	40,876	
Orange Savings Bank Livingston, New Jersey	September 28, 1984	514,919	494,642	
The Farmers & Merchants Bank Tecumseh, Oklahoma	October 5, 1984	27,741	27,577	
The Rexford State Bank Rexford, Kansas	October 10, 1984	5,657	5,244	2,398

INSURED BANK FAILURES (January 1, 1982 - October 11, 1985)
(Continued)

Name and location	Date of Closing or Deposit Assumption	Total Assets (000's)	Total Deposits (000's)	Brokered Deposits & Bureau of Indian Affairs (000's)
Oneida Bank & Trust Company Oneida, Tennessee	October 12, 1984	5,729	4,728	
Bucklin State Bank of Bucklin Bucklin, Missouri	October 12, 1984	13,457	13,853	
American State Bank Thomas, Oklahoma	October 19, 1984	22,279	20,424	
The Bank of Cody Cody, Nebraska	October 24, 1984	10,598	9,531	
Farmers State Bank Kilgore, Nebraska	October 24, 1984	5,810	5,212	
State Bank of Boyd Boyd, Minnesota	October 24, 1984	6,837	5,783	350
The First National Bank of Gaylord Gaylord, Kansas	October 25, 1984	6,517	6,002	
First American Banking Company Pendleton, Oregon	November 16, 1984	17,873	13,503	98
The Strong City State Bank Strong City, Kansas	November 29, 1984	4,394	4,320	
Golden Spike State Bank Tremonton, Utah	December 4, 1984	7,229	6,681	792
Farmers State Bank of Holyoke Holyoke, Colorado	December 7, 1984	3,498	3,455	
University Bank of Wichita Wichita, Kansas	December 11, 1984	5,089	4,696	
The Farmers State Bank Selden, Kansas	December 20, 1984	15,003	14,186	2,900
First Security Bank Sandwich, Illinois	December 22, 1984	9,700	10,118	
1985				
Citizens State Bank Edgerton, Wyoming	January 4, 1985	2,831	2,539	
State Bank of Dannebrog Dannebrog, Nevada	January 7, 1985	4,318	3,764	
Coast Community Bank Harbor, Oregon	January 11, 1985	9,054	8,385	
The First National Bank in Marlow Marlow, Oklahoma	January 24, 1985	27,451	26,071	
First National Bank in Clarksville Clarksville, Texas	January 24, 1985	29,248	18,559	
The Steele State Bank Cherokee, Iowa	January 25, 1985	19,277	17,682	

INSURED BANK FAILURES (January 1, 1982 - October 11, 1985)
(Continued)

Name and location	Date of Closing or Deposit Assumption	Total Assets (000's)	Total Deposits (000's)	Brokered Deposits & Bureau of Indian Affairs (000's)
Citizens Fidelity Bank Bristol, Tennessee	February 1, 1985	16,360	14,104	298
First National Bank of Woodbine Woodbine, Iowa	February 7, 1985	26,774	24,927	
Farmers National Bank of Erick Erick, Oklahoma	February 7, 1985	17,659	15,899	
Peoples Bank and Trust Company Wartburg, Tennessee	February 8, 1985	23,122	20,058	6,400
West Valley Bank Woodland Hills, CA	February 8, 1985	61,169	34,499	17,600
First National Bank of Eads Eads, Colorado	February 14, 1985	16,906	15,139	
Citizens State Bank of Fulda Fulda, Minnesota	February 15, 1985	38,095	34,962	
Inwood State Bank Inwood, Iowa	February 19, 1985	7,094	6,906	
Halifax National Bank of Port Orange Port Orange, Florida	March 1, 1985	38,234	35,457	
Citizens State Bank Arapahoe, Nevada	March 8, 1985	15,675	14,282	
Commercial State Bank Afton, Iowa	March 8, 1985	15,908	15,401	
Taylor State Bank Emington, Illinois	March 15, 1985	4,789	4,517	
Golden Valley Bank Turlock, California	March 22, 1985	72,291	65,325	2,100
Fidelity Bank of Denver Denver, Colorado	March 29, 1985	43,979	27,176	2,400
The Bank of Hunter Hunter, Oklahoma	April 4, 1985	2,860	2,755	
Capistrano National Bank San Juan Capistrano, CA	April 5, 1985	51,102	41,091	2,500
State Bank of Alexandria Alexandria, Nebraska	April 11, 1985	2,559	2,430	
First State Bank of Elgin Elgin, Oregon	April 12, 1985	17,776	14,888	
South Coast Bank Costa Mesa, California	April 12, 1985	31,737	26,658	2,500
Peoples National Bank of Lampasas Lampasas, Texas	April 18, 1985	33,854	32,884	

INSURED BANK FAILURES (January 1, 1982 - October 11, 1985)
(Continued)

Name and location	Date of Closing or Deposit Assumption	Total Assets (000's)	Total Deposits (000's)	Brokered Deposits & Bureau of Indian Affairs (000's)
The First National Bank of Springfield Springfield, Colorado	April 18, 1985	15,274	13,211	
Peoples State Bank Odebolt, Iowa	April 26, 1985	13,294	12,511	
First Enterprise Bank Oakland, California	April 26, 1985	40,803	31,575	
The Bank of Commerce Chanute, Kansas	May 2, 1985	67,131	62,594	
Farmers Savings Bank Massena, Iowa	May 3, 1985	66,102	63,238	
Farmers State Bank, St. Joseph St. Joseph, Missouri	May 3, 1985	49,585	45,986	
Story County State Bank Story City, Iowa	May 9, 1985	32,654	31,186	
Bank of Newcastle Newcastle, Oklahoma	May 16, 1985	31,118	26,738	
The Energy Bank, N.A. Dallas, Texas	May 16, 1985	30,693	24,340	2,800
Northwest Bank White Settlement, Texas	May 23, 1985	51,906	47,103	
Bank of Taylor Taylor, Nebraska	May 31, 1985	13,829	12,225	
Scroggin & Company Bank Oak, Nebraska	May 31, 1985	3,219	2,755	
Security State Bank Edgar, Nebraska	May 31, 1985	5,785	5,233	
The Fairfield State Bank Fairfield, Nebraska	May 31, 1985	6,184	5,382	
Bank of Lockesburg Lockesburg, Arkansas	May 31, 1985	27,171	24,491	
First Trust Bank of Lakefield Lakefield, Minnesota	May 31, 1985	23,849	20,643	
Bank of Oregon Woodburn, Oregon	May 31, 1985	108,756	99,573	
American National Bank of Riverton, Riverton, Wyoming	June 11, 1985	36,827	35,982	
The First State Bank Edna, Kansas	June 13, 1985	8,503	8,336	
Swift County Bank Benson, Minnesota	June 14, 1985	39,603	37,332	
Strong's Bank Dodgeville, Wisconsin	June 14, 1985	33,443	30,156	1,100

INSURED BANK FAILURES (January 1, 1982 - October 11, 1985)
(Continued)

Name and location	Date of Closing or Deposit Assumption	Total Assets (000's)	Total Deposits (000's)	Brokered Deposits & Bureau of Indian Affairs (000's)
Farmers State Bank of Dexter Dexter, Kansas	June 20, 1985	3,902	3,657	
Urbana Savings Bank Urbana, Iowa	June 21, 1985	7,228	6,316	
First City Bank, N.A. Oklahoma City, Oklahoma	June 21, 1985	92,217	84,367	5,700
Golden Pacific National Bank New York, New York	June 21, 1985	166,009	148,678	
First Bank and Trust Tracy City, Tennessee	June 28, 1985	21,493	19,650	
Madison Bank Madison, Kansas	July 2, 1985	8,552	7,819	
The First National Bank of Jacksonville Jacksonville, Alabama	July 5, 1985	43,624	39,663	
Crossroads State Bank Oklahoma City, Oklahoma	July 11, 1985	17,162	16,414	3,500
Eskridge State Bank Eskridge, Kansas	July 18, 1985	10,552	9,278	
The First National Bank of Darrouzet Darrouzet, Texas	July 18, 1985	12,987	11,543	
Linn County Bank Linneus, Missouri	July 19, 1985	5,023	5,087	
Gilpin County Bank Blackhawk, Colorado	July 19, 1985	3,802	3,461	
The First National Bank of Onaga Onaga, Kansas	July 23, 1985	20,047	19,684	
First National Bank of Glenrock Glenrock, Wyoming	July 23, 1985	19,427	16,933	
Kansas American Bank Overland Park, Kansas	July 25, 1985	25,743	22,531	992
Citizens State Bank of El Dorado El Dorado, Kansas	July 23, 1985	27,116	25,846	
Riverside National Bank Houston, Texas	August 1, 1985	18,586	16,669	
Farmers State Bank Rising City, Nebraska	August 2, 1985	12,938	11,457	
Farmers State Bank of Round Lake Round Lake, Minnesota	August 2, 1985	22,955	20,567	
Mineola State Bank Mineola, Iowa	August 6, 1985	5,056	4,828	
Security Bank and Trust Company Midwest City, Oklahoma	August 8, 1985	32,837	31,493	

INSURED BANK FAILURES (January 1, 1982 - October 11, 1985)
(Continued)

Name and location	Date of Closing or Deposit Assumption	Total Assets (000's)	Total Deposits (000's)	Brokered Deposits & Bureau of Indian Affairs (000's)
State Bank of Farmersville Farmersville, Illinois	August 9, 1985	11,166	10,985	
State Bank of Herndon Herndon, Kansas	August 14, 1985	6,174	5,545	
Park West Bank, N.A. Farmers Branch, Texas	August 15, 1985	19,167	16,920	
The Commercial Bank Andalusia, Alabama	August 16, 1985	89,129	75,827	
The Bank of Bronson Bronson, Kansas	August 23, 1985	9,001	8,585	
Missouri Delta Bank Hayti, Missouri	August 28, 1985	8,278	7,481	
Cardwell State Bank Cardwell, Missouri	August 28, 1985	5,994	5,545	
Moncor Bank, N.A. Hobbs, New Mexico	August 30, 1985	208,059	115,953	
The Bank of Loretto Loretto, Tennessee	September 4, 1985	24,659	24,013	
Bank of Clifton Clifton, Colorado	September 6, 1985	10,374	10,021	
First Security Bank of Dickson Dickson, Tennessee	September 12, 1985	15,413	14,751	1,000
Moncor Bank, N.A. Roswell, New Mexico	September 12, 1985	33,545	24,256	
Peoples National Bank of Rockland County Ramapo, New York	September 13, 1985	22,085	18,522	2,700
Elba State Bank Elba, Nebraska	September 18, 1985	4,059	3,562	
The Sedan State Bank Sedan, Kansas	September 25, 1985	25,664	24,285	
Western State Bank of Denton, Texas Denton, Texas	September 27, 1985	24,597	21,428	3,300
The First National Bank of Terral Terral, Oklahoma	September 27, 1985	3,302	3,169	
Bowery Savings Bank New York, New York	October 1, 1985	5,295,608	5,000,000	
Tower Bank, N.A. Hialeah Gardens, Florida	October 3, 1985	15,442	14,539	1,200
Bank of Canton Canton, Oklahoma	October 10, 1985	18,025	17,949	
Saratoga State Bank Saratoga, Wyoming	October 11, 1985	16,809	16,367	
The First National Bank of St. Joseph St. Joseph, Missouri	October 11, 1985	178,205	149,240	

Chairman HUBBARD. Thank you.

Chairman Isaac, what is the total of brokered deposits at FDIC insured institutions?

Mr. ISAAC. The total brokered deposits in all FDIC insured institutions, as of about the third or fourth quarter of last year, was $24 billion.

Chairman HUBBARD. What share of the amount is insured?

Mr. ISAAC. We really don't know. It is very difficult to get that information. Part of the problem is that some of your larger brokering houses, like Merrill Lynch and Dean Witter, for example, purchase very large CD's from a bank in bearer form, and then they take those CD's and subdivide them or participate them out among various investors.

So at any given time you don't know who is holding the beneficial interest in those and to what extent they are insured.

We are about to come out with a proposed new regulation requiring the names of the beneficial holders to be listed on the books and records of the banks in order to obtain insurance coverage. That will give us access to the information about insurance coverage that we need so we can make these kinds of determinations.

I would tell you that of the $24 billion in total brokered deposits in the banking system, $9 billion was placed in three-, four-, and five-rated institutions. It is hard for me to believe that much of that $9 billion is uninsured.

I don't believe brokers are willing to take that risk or their customers. I would be surprised if you would find that very much of the $9 billion is uninsured.

Chairman HUBBARD. On page 8 of your statement you have stated, "In January of this year the FDIC instituted a monthly reporting requirement for all FDIC insured banks and thrifts holding fully insured brokered and financial institution deposits in excess of either the institution's capital or 5 percent of deposits."

Have those institutions been cooperative and compliant thus far and has the FDIC been able to use that information to target institutions with large amounts of brokered deposits?

Mr. ISAAC. For the most part, the institutions, I believe, have tried to be cooperative, though any time you come up with a new reporting requirement you always have a lot of confusion about what it means and how to comply with it. The FDIC has found the reports enormously useful in targetting our resources.

Every month we send out lists of banks that show up on deposit listing services as paying significantly above market rate of interest and also lists of banks that are using extensive amounts of brokered funds to our examiners in our regional offices for followup surveillance.

Those banks get visited by our people more regularly than do banks not using brokered funds.

Chairman HUBBARD. Would you be able to provide the subcommittee with any data thus far collected as a result of this new reporting requirement?

Mr. ISAAC. I believe we can, yes.

Chairman HUBBARD. Please do at your first opportunity.

[In response to the request of Chairman Hubbard, the following information was submitted for the record by Chairman Isaac:]

September 13, 1985

MEMORANDUM TO: William M. Isaac
Chairman

ATTENTION: Christie A. Sciacca
Assistant to the Deputy
to the Chairman

FROM: A. David Meadows, Associate Director
Division of Bank Supervision

SUBJECT: Brokered Deposits

Attached is a summary of Regional Office reports of brokered deposits, as of July 31, 1985, submitted in accordance with 12 C.F.R. Part 304, Section 304.4. An aggregation by type of bank is also included. Additional information regarding brokered deposits has also been supplied. This data has been analyzed and compiled into several charts which are also attached.

Attachments

ALL REGIONS
SECTION 304.4 REPORTS SUMMARY
July 31, 1985

	Nonmember Banks			State Member Banks			National Banks			Branches of Foreign Banks		
	Number	B/D	F/I	Number	B/D	F/I	Number	B/D	F/I	Number	B/D	F/I
FDIC-insured banks reporting current month	108	1,220,891	462,627	12	30,878	9,500	80	4,730,210	302,673	7	1,274,434	8,540
FDIC-insured banks reporting previous month	113	1,222,815	452,553	14	151,391	14,221	75	4,764,386	267,696	7	1,226,461	8,640
Increase/(Decrease)	(5)	(1,924)	10,074	(2)	(120,513)	(4,721)	5	(34,176)	34,977	0	(47,973)	(100)
FDIC-insured banks reporting current month but not previous month	9	187,231	12,191	1	0	500	9	12,260	12,191	0	0	0
FDIC-insured banks reporting previous month but not current month	13	147,658	69,159	3	120,500	2,521	4	431,800	1,025	0	0	0
Reason for not reporting current month:												
Reportable deposits less than 5% of total deposits	5	N/A	N/A	3	N/A	N/A	4	N/A	N/A	0	N/A	N/A
Reportable deposits less than 100% of capital	8	N/A	N/A	0	N/A	N/A	0	N/A	N/A	0	N/A	N/A
Merged with other bank	0	N/A	N/A	0	N/A	N/A	0	N/A	N/A	0	N/A	N/A
Bank closed	0	N/A	N/A	0	N/A	N/A	0	N/A	N/A	0	N/A	N/A
Change in definition	0	N/A	N/A	0	N/A	N/A	0	N/A	N/A	0	N/A	N/A
		Number			Number			Number			Number	
Visitations Performed:												
FDIC		4			0			0			1	
Other bank regulator		0			0			0			0	
Corrective Actions Started:												
FDIC		23			0			1			0	
Other bank regulator		0			3			3			0	

B/D = Brokered Deposits ($000)
F/I = Deposits placed directly by financial institutions ($000)

Type of Bank	Number	Brokered Deposits	(000 omitted) Financial Institutions
Nonmember Banks	108	1,220,891	462,627
State Member Banks	12	30,878	9,500
National Banks	80	4,730,210	302,673
Savings Banks and Branches of Foreign Banks	7	1,274,434	8,540
Total	207	7,256,413	783,340

			(000 omitted)	
Month Ending	Total Number	Brokered Deposits	Financial Institutions	Total
July 31, 1984 (revised)	237	17,263,537	528,742	17,792,279
September 30, 1984 (revised)	226	17,577,842	634,726	18,212,568
December 31, 1984 (revised)	228	17,894,473	700,521	18,594,994
March 31, 1985 (revised)	227	5,985,767	686,623	6,672,390
June 30, 1985	209	7,365,053	743,110	8,108,163
July 31, 1985	207	7,256,413	783,340	8,039,753

B/D TO CAPITAL AND RESERVES#

Composite		0% to 50.0%	50.1% to 100.0%	100.1% to 150.0%	150.1% to 200.0%	200.1% to 300.0%	Greater than 300.0%	Total
1	July	55	36	9	1	3	4	108
and	June	46	36	11	1	4	4	102
2	May	44	33	15	4	4	3	103
	July	11	13	9	3	2	0	38
3	June	13	16	7	2	2	1	41
	May	15	15	6	0	2	0	38
4	July	17	10	9	2	3	5	46
and	June	17	14	8	3	2	7	51
5	May	18	13	11	2	3	9	56
	July	9	1	1	1	1	0	13
New	June	9	2	0	1	0	1	13
	May	10	2	1	0	2	0	15
	July	92	60	28	7	9	9	205
Total	June	85	68	26	7	8	13	207
	May	87	63	33	6	11	12	212

B/D PLUS F/I TO CAPITAL AND RESERVES#

Composite	0% to 100.0%	100.1% to 200.0%	200.1% to 300.0%	Greater than 300.0%	Total
1 and 2	70	23	7	8	108
3	14	16	3	5	38
4 and 5	11	16	3	16	46
New	8	4	1	0	13
Total	103	59	14	29	205

#Figures do not include two branches of foreign banks:

B/D PLUS F/I TO TOTAL DEPOSITS

Composite	Less than 5.0%	5.0% to 10.0%	10.1% to 20.0%	Greater than 20.0%	Total
1 and 2	1	61	35	12	109
3	1	22	8	8	39
4 and 5	1	16	17	12	46
New	0	6	6	1	13
Total	3	105	66	33	207

GROWTH RATE

Composite	N/A	Less Than 0.0%	0.0% to 50.0%	50.1% to 100.0%	Greater than 100.0%	Total
1 and 2	7	6	67	19	10	109
3	1	9	23	4	2	39
4 and 5	0	18	22	4	2	46
New	12	0	1	0	0	13
Total	20	33	113	27	14	207

This schedule ranks the reporting banks by their growth rate within their various Composite ratings. Of primary concern are those banks which have had a growth rate in excess of 100 percent. It should be noted that the number of reporting banks has decreased from 209 to 207 and the number of banks showing a growth rate in excess of 100.0% has decreased from 20 to 14.

B/D TO TOTAL DEPOSITS

Composite	Less than 5.0%	5.0% to 10.0%	10.1% to 20.0%	Greater than 20.0%	Total
1 and 2	40	50	11	8	109
3	14	17	4	4	39
4 and 5	21	14	8	3	46
New	8	3	2	0	13
Total	83	84	25	15	207

Composite	Nonmember Bank	State Member Banks	National Banks	Savings Banks and Branches of Foreign Banks	Total
1	7	1	17	2	27
2	43	4	33	2	82
3	26	4	7	2	39
4	15	2	14	1	32
5	12	0	2	0	14
New	5	1	7	0	13
Total	108	12	80	7	207

SUPERVISORY ACTION TAKEN, CONTEMPLATED OR IN PROCESS

Composite	No Action	MOU	Visitation	Examination	Formal Agreement/ Administrative Action	Cease and Desist Order	Bank Resolution/ Commitment	Monitoring	Other	Total
1 and 2	65	2	6	20	2	0	1	13	0	109
3	13	12	0	2	6	2	0	4	0	39
4 and 5	3	4	1	4	7	25	0	2	0	46
New	6	0	0	5	0	0	1	1	0	13
Total	87	18	7	31	15	27	2	20	0	207

Chairman HUBBARD. On page 10, Chairman Isaac, you support a cap for insured brokered deposits at 100 percent of an institution's capital and you state that this generous limit ought to satisfy the fee-generating appetite of the brokerage industry for years to come.

Will this cap have the effect of denying small and medium sized depository banks and thrifts full opportunity to compete with money center banks for funds?

Mr. ISAAC. Let me clarify a couple of things. One, is that I didn't support that cap. I tried not to at least.

I would be willing to reluctantly accept that kind of cap. I think the better approach is to rely on the market forces and simply limit the insurance coverage on brokered funds. That way the brokers will be forced to put the money in institutions that are creditworthy.

But if we must have a cap, a cap equal to 100 percent of capital or 5 percent of deposit, something along those lines, would be acceptable. As for it limiting the ability of smaller banks to compete with the money center banks, it would not in my judgment have that effect.

Keep in mind, not very many banks use brokered funds to begin with. A total of 650 or so banks in the country use brokered funds at all and approximately 230 of those banks are troubled. So well-run banks don't use brokered funds very much.

Chairman HUBBARD. This question to Mr. Selby.

On page 3 of your prepared statement you advise the subcommittee that, "the use of brokered deposits within the national banking system is far from pervasive. As of March 31, 1985, national banks held over $1.1 trillion in deposits. Less than 1½ percent of all deposits were reported to have been placed by brokers."

Relatively speaking, Mr. Selby, why does the national banking system seem to have such a low occurrence of usage of brokered deposits? Why does the Comptroller's Office depart from the position of the other regulators and feel that the procedures are in place to make sure that brokered deposits are not used to turn small problem banks into big problem banks overnight?

Mr. SELBY. I will try to answer the several parts of your question.

As Mr. Isaac said, there were $24 billion in brokered deposits in the system. Of that, national banks had $16 billion in total brokered deposits, wholesale and retail as of March 1985. The retail portion in the national banking system, that is the insured portion of the $16 billion, was approximately $5 billion. So the national system does have the largest proportion of the $24 billion in brokered deposits.

What I said was that I thought that we have the authority now to control the improper use of brokered deposits. I agree with Mr. Isaac that it is sometimes after the fact that we can address the problem, after the brokered deposits are already in the bank. Since early 1984, almost all of the administrative actions we have taken against national banks have included a clause either requiring monthly reporting of brokered deposits or limiting the bank's use of such deposit.

But it is not the brokered deposits that create the problem; it is how the banks use those brokered deposits. As a matter of fact, with problem banks which do not have brokered deposits, more times than not it is a case of management using the local deposit base to make bad loans.

Chairman HUBBARD. Thank you.

Another question to Mr. Selby. Chairman Isaac has said that sound banks don't use brokered funds. Do you agree with that statement?

Mr. ISAAC. If I could elaborate a little bit.

I said for the most part sound banks are not using brokered funds. I am sure there are some sound banks that make some use of brokered funds. All I meant to say is that it is not a widespread practice.

Chairman HUBBARD. I apologize for misquoting you.

Do you agree with that statement by Chairman Isaac?

Mr. SELBY. That depends on how you are defining brokered deposits. If you are including both wholesale and retail deposits, I do not agree because a lot of large institutions participate in the wholesale brokered deposits business, that is large uninsured CD's over $100,000.

I think he is correct in saying that the abuses that we have found have been in banks using brokered deposits to fund their growth. In such instances perhaps we are at fault in not ferreting out the ability of management or their systems or policies before they make the loans.

Mr. ISAAC. Mr. Chairman, if I could say one word because I want to be very clear on this.

We do not consider the brokered deposits market to involve the uninsured brokered deposits to which Mr. Selby referred. That is not where the problem is at all.

We don't even consider that broker deposit usage. We are talking about fully insured brokered deposits.

Fully insured brokered funds are not used by very many banks, 650-some in total, but when they are used they are often abused.

More than a third of the banks using them are troubled banks.

Chairman HUBBARD. One last question from me at this point to Mr. Selby. On page 3 of your testimony, Mr. Selby, you state that less than one-half percent of the brokered deposits, retail brokered deposits, are fully insured by the FDIC. In light of that statistic and your testimony that the Comptroller of the Currency has had such positive results with your enforcement procedure with potentially troubled banks, why do you call for stricter regulation?

In other words, a $100,000 limit on insurance coverage of a depositor of funds placed through any single broker and reform of the Federal insurance system?

Mr. SELBY. While we believe the supervisory issues raised by deposit brokering can be handled under existing regulatory authority, we feel reforms are needed to deal with the reduced market discipline and increased exposure of the insurance funds brought about when large depositors split their funds into fully-insured increments. That is why it is important that deposit insurance reform be addressed by the Congress—to correct these and other problems in the insurance area.

Chairman HUBBARD. Thank you both for answering my questions.

Before I call on our ranking minority member, Congressman Parris, I would invite those who are standing at the door to take seats. We would be happy to have you to do that, so others could come in also.

If we could take just a moment for these people to take the seats that are vacant, I would say that if a few of you would come in the other door, there are three or four seats on the other side.

Thank you for your attention to that request.

Now, Congressman Parris, questions?

Mr. PARRIS. Thank you very much, Mr. Chairman.

Just a couple of quick observations.

The first one, and I planned on making this Mr. Selby even before you informed us that you are now a constituent of mine.

On page 4, I congratulate you for a good definition of the problem and the reason for this hearing. When you say that brokered deposits can hasten the deterioration of a distressed or poorly managed institution, that is really what we are trying to get at here.

Second, it minimizes market discipline while increasing exposure of the insurance funds. That is, I think, a too extensive definition of the problem which I know concerns you gentlemen and is of increasing concern to us.

One other quick observation.

In schedule C Mr. Isaac of your testimony, on troubled FDIC insured banks and thrifts, first on the list, Merrill Lynch, three-quarters of a billion dollars; Dean Witter Reynolds, half a billion dollars; Prudential-Bache Associates, $131 million; First Boston Co., $115 million, et cetera.

These are the same securities firms who want to keep the banks out of the securities business, the same securities firms that want to be in the banking business, the same people that we hear from on H.R. 20, that infamous vehicle that we have been kicking around here for 4 years and haven't seen the birth of yet, these are the same people?

Mr. ISAAC. I believe they are.

Mr. PARRIS. I believe they are, too.

Let me quickly, Mr. Chairman, deal with the question of fees. I am curious and I understand fees for these brokers vary to some large degree with the maturity. Is there a number, an average number that if I am a brokered deposits broker that I am compensated by the people who make and receive the deposits?

Mr. ISAAC. Incidentally, before I answer that, I don't want Mr. Selby to get away with something on me. I am also a constituent, I should point out.

Mr. PARRIS. I knew this was a marvelous panel.

Mr. ISAAC. I don't know the fee structure. Maybe the brokers can help you with it in terms of how they get paid. I expect some of them get paid at both ends.

I would point out that this business, according to everyone that I have talked to about it, and I recently had a conversation with a very high level executive of one of the major brokerage firms, is an enormously lucrative business. There is a lot of money to be made, very little overhead.

He referred to this business as a "no brainer we take money from investors, and package it into fully insured CD's. We don't have to do any credit analysis. There is virtually no overhead involved."

Mr. PARRIS. And you give it to an insured financial institution whose management has no brains as well?

Mr. ISAAC. That is too often the case.

Mr. PARRIS. One part of that that worries me, Mr. Isaac, and I hope it would you, is the question of tied loans. In some instances when you provide adequate funds to some troubled institution there is a tied loan arrangement coming back which exacerbates the problem.

You take questionable funds when you are a troubled institution and loan it back in a non-credit-worthy transaction which makes the problem doubly difficult, doesn't it?

Mr. ISAAC. Yes; in fact, we had a bank that failed recently in Wisconsin, the Strongs Bank in Dodgeville, WI, failed on June 14. There we had about $1.1 million in fully insured brokered funds that were brought in and put out in what appears to be fraudulent linked loans.

We are investigating right now to determine to what extent, if at all, the broker was involved in originating the fraudulent loans. If the broker was involved in the fraud, we are not going to pay the brokered funds.

This is a serious problem and we will do everything possible to deal with it.

Mr. PARRIS. I understand. In that case, when the deposits represent 4 percent, how about Woodland Hills, CA, where the deposits are 53 percent? That is not a direct correlation but in one instance you indicate that three-fourths of the deposits of the institution are brokered deposits.

Mr. ISAAC. Sure. The Sparta Sanders State Bank, in Sparta, KY, failed on April 15, 1983. I hadn't heard of the bank before it failed, and I don't imagine very many people in the world had ever heard of it but a bunch of financial institutions did and 76 percent of the money in the Sparta Sanders State Bank was supplied by money brokers from these sources—fully insured.

Why? Why would all this money rush to the Sparta Sanders State Bank?

Mr. PARRIS. Greed and avarice.

Mr. ISAAC. That is what I would call it.

Mr. PARRIS. My time is running quickly by.

One or two other quick comments here. In today's Wall Street Journal, gentlemen, the headline says Federal bank examiners are drawing fire and, among other things, it quotes both of you gentlemen in your official capacities, of course.

I have long believed that one of the reasons that more 7-11's are not held up is because there are policemen around in various communities. The reason most of us pay our taxes is very simple, we are afraid of being caught.

Sometimes some of us subjugate that fear to the greed and the avarice we just talked about, which is part of human nature, I suppose, but this article, I don't know whether you have had an opportunity to see it yet or not, makes a couple of observations.

One is the congressional concern is growing that Federal bank overseers are falling asleep at the switch. I certainly would not allege that to two constituents.

It goes on to say the confidence in the entire banking system depends on examiners and their experience and to some degree I relate to that principle, and it says the number of examiners is down since 1980 on FDIC, Comptroller of Currency, Federal Reserve Board, et cetera.

It talks some about the reduction in what they suggest is a lack of confidence and the thing—in the individual examiners, and the question about surprise examinations—I served on a board of a S&L and on a national bank. In those days we used to kind of live in fear that the examiners would come marching through the door and start slapping seals on everything and everybody would go bananas trying to jerk out files and that sort of thing they wanted to look at.

It was like Wyatt Earp riding into town. Now, as I understand, in an attempt to give the banks an opportunity to have the information available, there is less of that spontaneity in the process. Maybe this is more of a speech than it is a question, but my question to you, and I know that you have, Mr. Isaac, started what is called gut wrenching reviews of examiners' shortcomings and mistakes after every bank failure, but it seems to me we ought to wrench the guts of a few of the bankers who have an opportunity to get prepared for your examiners.

My question is, it says, quote, here, FDIC Chairman Isaac and Acting Comptroller H. Joe Selby, argue that the declining number of examiners should be allocated to the larger and the troubled banks. It seems to me, and you alluded to this a moment ago, Bill, you can't tell.

You can look in the business section of the Washington Post and watch the Maryland privately insured S&L's give 1.5 and 2 and 3 percent higher interest rates, you can track the higher than average market rates on CD's and those in trouble.

Why can't you—why shouldn't you take your examiners, first of all you argue about whether you have enough or not, but those that you have got, I mean the walking wounded. Why not apply them to the institutions that are really in trouble?

You know where those are?

Mr. Isaac. That is what we are doing. Let me clarify a few things that I think the article didn't accurately reflect. The number of examiners may well have been done from 1980 to some point in time, but we are actively hiring examiners.

Due to the increasing number of problem banks and the high level of failures, which has been persisting, we are substantially increasing our work force right now and have been doing so for over a year.

As for where we are putting our resources, the article gave the impression that there is some kind of a divergence of opinion among the agencies, and I don't think there is.

I think all of us believe that on site exams are critical, that you can't do it all offsite, and I think that we all believe that we have limited numbers of personnel so you must target those personnel where they are most needed.

We try to target our people, and I know the Comptroller does as well on larger institutions and on institutions that are troubled or show up in our offsite monitoring system as having potential troubles.

I don't think that any of the agencies disagree with that approach.

Mr. PARRIS. So it is not a quarrel about whether or not we should have onsite inspections as Mr. Partee of the Federal Reserve——

Mr. ISAAC. Not at all.

Mr. PARRIS. With apologies to my colleagues, one last question.

You say on page 9, Mr. Isaac, we have received virtually no help from the Congress during the past 2 years as we have struggled to contain the serious threat to the insurance system.

There are some of us who believe that this committee and this Congress should have done something about a banking bill a long time ago. What would you have us do?

Mr. ISAAC. In the brokered deposits area, that is what I was referring to. There are a lot of things I would have the Congress do generally in the banking area, but dealing with brokered deposits, if the Congress is going to do anything, I would prefer a bill that limits insurance coverage on brokered deposits.

If that is not acceptable, I would be willing to accept a good, strong cap bill with a reasonable cap that doesn't take away our enforcement authority in any way, and does not distinguish between long and short term funds.

That would be my second choice. My third choice would be for the Congress to do nothing

Mr. PARRIS. You previously endorsed risk-related insurance.

Mr. ISAAC. Yes. There are a lot of things I would do in the area of deposit insurance reform, We have a bill pending, and I am pleased to hear that the House and Senate committees will take up hearings on that question.

Mr. PARRIS. One day we will visit the question of should we amalgamate all the supervisory institutions into one giant bureaucracy, but that is for another day.

Thank you.

Chairman HUBBARD. Thank you, Congressman Parris.

We do appreciate Mr. Isaac giving us his opinions as to what Congress should do. I can remember there have been times in this room when he has been told we are not interested in that—I am talking about your opinion—unless you run for Congress.

Congressman David Dreier, I believe you were next.

Mr. DREIER. Thank you very much, Mr. Chairman.

I, first of all, would like to compliment you on calling these hearings. I know there is another subcommittee of another full committee which has focused a great deal of attention on this question.

Chairman Isaac alluded to their fine work and I think we have the chairman of that subcommittee in the room.

Mr. BARNARD. Did you say fine work?

Mr. DREIER. Yes.

I would like to ask Chairman Isaac, you and I have on several occasions on these panels discussed the question of insurance reform and I would like to hear your comments on how closely you tie the whole question of insurance reform to the problem of brokered deposits.

Mr. **Isaac**. I think brokered deposits is one symptom of the need to reform the deposit insurance system. We have got a couple of different problems in the deposit insurance area to deal with.

One is the question of fairness. How are large bank failures going to be handled and how are small bank failures going to be handled—in a different or in the same fashion?

I think it is unacceptable to handle them in a different fashion. We have to find a common method for handling bank failures of all sizes from the point of view of fairness.

Is it fair for the best bank and the worst bank in the country to pay the same deposit insurance premium as they do today?

I think not. Is it fair that large banks have nearly half their deposits abroad and don't pay premiums on them, whereas smaller banks with 100 percent of their deposits in the United States pay premiums on the full amount?

So we have a question of fairness. Also, we have a question of the soundness of the system, the discipline in the system. Is everybody going to be bailed out all the time when a bank fails?

The broker deposits problem is part of that. The insurance system can't continue to operate in a way that bails everybody out every time a bank fails. We have to find a way to encourage the money to flow to the good banks instead of the high rollers.

Mr. **Dreier**. Since Chairman Hubbard pointed out the fact that your opinions are welcome in this subcommittee at least, would you care to prognosticate as far as the potential for major reform in the area of insurance?

You mentioned the fact that Chairman Garn has agreed to hold hearings.

Mr. **Isaac**. I am very optimistic about it.

The ABA is keenly interested in it. The Vice President's Task Group on Reform of the Regulatory System has endorsed a number of changes in the deposit insurance area.

The Cabinet Council on Economic Affairs has a working group that has endorsed significant changes in the deposit insurance area. Chairman Garn and Chairman St Germain are holding hearings.

I believe we have the momentum going now and are going to see major reform.

Mr. **Dreier**. We talked about the question of your having provided those monthly reports since January. Do you feel that you are adequately staffed to deal with the necessary inspections?

Mr. **Isaac**. More or less, though we do have to have a substantial addition right now to our examiner corps. That is because the number of problem banks continues to rise. It is just under a thousand now. The previous peak was in 1976 when we had 378 problem banks.

Problem banks require a lot more supervision.

Also, when you have bank failures at the rate of 79 last year and it will probably be 100 this year and next, those require a lot of resources. So while we have been able to get the work done, we are now shorthanded and we are hiring a significant number of examiners.

Mr. **Dreier**. Do you need any assistance from us to try to increase that?

Mr. **Isaac**. If you would free us up from some of the arcane civil service rules, we would find ourselves in a much better position to hire people and retain them. I am talking about salaries and I am talking about all of the procedures you have to go through.

It seems like it takes 6 to 9 months to hire a person.

Mr. **Dreier**. My recommendation on that, Mr. Chairman, would then be for you to contact your Congressman.

Thank you very much, Mr. Chairman.

Mr. **Isaac**. Was he listening?

Chairman **Hubbard**. Thank you, Congressman Dreier.

Congressman Barnard.

Mr. **Barnard**. Thank you, Mr. Chairman.

I guess this is somewhat like deja vu. I don't know how much has changed since our last encounter on this subject. The purpose of these hearings this morning is to study the impact of brokered deposits on banks and thrifts and their risk versus their benefits, but I guess my first question would be, since this issue was addressed previously, what is the recent experience with brokered deposits? Is this better or worse than it was 12 months ago?

Mr. **Isaac**. I guess my reaction would be that it is probably somewhat better in FDIC insured institutions. My impression is it is not necessarily better, perhaps worse, in FSLIC institutions, but Ann Fairbanks will testify next and can enlighten you on that.

I feel because of the steps taken over the past couple of years the problem is not quite as serious today as it would have been a year ago, though if we were to relent in our efforts, it would become a problem of massive proportions.

Mr. **Barnard**. Mr. Selby?

Mr. **Selby**. I think it is becoming less of a problem. If you look at the supplement to Mr. Isaac's testimony, you will see that at least those problem banks that failed had a lower percentage of brokered deposits than such failed banks previously. Since early 1984 when we started including restrictions and limitations on brokered deposits or at least more frequent reporting requirements in enforcement actions, we have seen noticeable improvement in our ability to monitor the usage of brokered deposits.

Mr. **Barnard**. Please respond yes or no to these three propositions. First, I think we have already addressed it—the vast bulk of brokered deposits in FDIC insured banks are in the large billion dollar institutions.

Mr. **Isaac**. Is that a question?

Mr. **Barnard**. Yes.

Mr. **Isaac**. True.

Mr. **Barnard**. OK. Yet—but the most concrete examples of brokered funds abuse have been more isolated in the smaller institutions. That is true; right?

Mr. **Isaac**. Largely, but let me give you one.

Mr. **Barnard**. I am talking about generally. I am not speaking specifically.

Mr. **Isaac**. I want to talk about a specific because I think it is a good example.

Mr. **Barnard**. They told me my time is unlimited.

Mr. **Isaac**. It is a good example of the kind of situation we could be dealing with more and more frequently if we don't do something. I want to preface my remarks by saying that everything I am telling you comes out of this Wall Street Journal article.

There is no confidential supervisory information I am giving on this——

Mr. **Barnard**. We get most of our confidential information from the Wall Street Journal.

Mr. **Isaac**. And I am not in any way trying to call into question the soundness of this institution. I am just reporting facts as reported in the Wall Street Journal.

As far as I know this is a perfectly fine institution without a problem.

Mr. **Barnard**. Is it State chartered?

Mr. **Isaac**. It is an S&L, Columbia Savings & Loan, Beverly Hills. The article is dated June 7, 1985.

I will be happy to submit it for the record. This institution is $6.3 billion in assets. It has $4 billion in deposits, $2.5 billion, or 62.5 percent in the form of brokered deposits. According to the article, the subject's assets include $1 billion in junk bonds, and another $1 billion in investment grade, but unrated bonds.

The subject has net worth equal to 2.8 percent of assets.

All of the brokered deposits according to the article are long term. The bank last year put $1 billion in Ginnie Maes to speculate on a decline in interest rates in addition to the $2 billion in corporate bonds. The S&L last year originated only $200 million in mortgages, which is what I thought we chartered S&L's for.

This case represents a massive abuse of the Federal deposit system. I am not trying to say that it is a troubled institution. I am just telling you that the Federal Deposit Insurance system was not created to allow people to have unlimited access to federally guaranteed funds for the purpose of speculating in the bond markets.

Mr. **Barnard**. If that was a bank, what would you do about it?

Mr. **Isaac**. The practice would be substantially curtailed or we would replace management, the board of directors, and/or remove deposit insurance.

Mr. **Barnard**. If it was a bank that is what you would do, and I think that is good. But how about if the bank across the street had a few brokered deposits? Would you outlaw brokered deposits just because one bank used them wisely and another didn't?

Mr. **Isaac**. Would I outlaw brokered deposits if one bank used them wisely and one bank didn't? I have no problem with brokered deposits whatsoever. I don't want to outlaw them. I just don't want to insure them. I want them to go to the banks and thrifts that are creditworthy.

Mr. **Barnard**. Don't they do that in the great majority?

Mr. **Isaac**. No; not if they are insured. If they are uninsured, then they will go to the creditworthy institutions. The bulk of the fully insured funds are going to troubled institutions.

[The article referred to by Mr. Isaac from the Wall Street Journal of June 7, 1985 follows:]

WALL STREET JOURNAL, June 7, 1985

WHO'S NEWS

Columbia Savings' Chief, Spiegel, Invests $1 Billion of S&L Assets in 'Junk Bonds'

By Kathleen A. Hughes
Staff Reporter of The Wall Street Journal

BEVERLY HILLS, Calif. – When Thomas Spiegel was brought in by his father to run Columbia Savings & Loan Association eight years ago, he found the family-controlled thrift business dull and frustrating.

Things are livelier now. The 39-year-old former stock broker has hired karate and aerobics instructors for Columbia's two gyms and plans to hire a nutritionist to promote "health and wellness" at the thrift.

But he also put Columbia on a more controversial business path that some critics argue could be less than healthy for a savings institution. Under Mr. Spiegel's direction, Columbia has invested $1 billion of its $6.3 billion in assets in so-called "junk bonds" or high-yield, low-grade bonds.

Critics argue that junk bonds, which are sometimes used to finance takeovers, are too risky an investment for a thrift. But just how risky they are is hotly debated.

Thomas Spiegel

What's more, Columbia has another $1 billion in investment-grade or unrated bonds, which also prompts criticism. "S&Ls weren't put on this earth to have 33% of their assets in bonds. They were put on this earth to finance housing," says a top executive at one major thrift.

While some may argue with Mr. Spiegel's methods, they have a harder time arguing with the results to date. The thrift posted record earnings of $44 million, or $2.65 a share, for 1984 and Mr. Spiegel is predicting that earnings may double this year. Columbia's net worth is about $175 million, compared with $3 million when Mr. Spiegel took over as president and chief executive officer. His father, Abraham Spiegel, has remained chairman and the family holds about 60% of the stock.

Mr. Spiegel was the second-highest-paid executive in the thrift industry last year, with a salary and bonus totaling $1.3 million. He boasts that salaries of other Columbia executives are "way above the industry average"; last year he gave his chief financial officer a Mercedes as a bonus.

Although statistics aren't kept, observers believe Columbia is more heavily involved in junk bonds than any other large thrift. Mr. Spiegel says he was drawn into the market by Michael Milken, the head of the high-yield bond department at Drexel Burnham Lambert Inc. and a man credited with helping to create the junk bond market. "Most of what I learned (about the bond market) came from Drexel," says Mr. Spiegel. "Mr. Milken told me how terrible savings and loans were and I agreed."

But critics question just how well the relatively new junk bond market will hold up through the next business downturn. "Clearly, the junk bond market is untested in terms of going through the business cycle. There's a reason for the significantly higher yields of junk bonds," says Herbert Sandler, chairman and chief executive officer of Golden West Financial Corp. of Oakland, Calif.

Mr. Spiegel concedes that in the past he had worried about Drexel's dominance of the junk bond market and what that might mean to Columbia's ability to resell its bonds in a crunch. But now that several other brokerage firms recently have come into the market, Mr. Spiegel adds, Columbia's dependence on Drexel has declined.

Mr. Spiegel claims that a diversified and well-managed junk bond portfolio isn't much riskier than other types of investments, such as home mortgages and commercial loans. And the reward is much greater, he adds. Columbia's corporate bond portfolio currently yields about 14%, compared with about 12.5% for its home mortgages. To reduce the danger in buying riskier securities, the thrift keeps nine research analysts to evaluate the bonds, which are spread throughout 13 different industries and 200 companies including Metromedia Inc., Golden Nugget Inc. and Charter Medical Corp.

So far, the thrift has lost only $1 million as a direct result of a credit problem on a bond, says Mr. Spiegel.

Takeovers to Be Avoided

While junk bonds are often associated with the financing of hostile takeovers, Mr. Spiegel says that so far Columbia has helped finance only two. He won't identify them, but says he's planning to stay away from any more. "As long as hostile takeovers are such a hot issue we're better off not getting involved," he says.

Since Columbia doesn't list all the bonds it holds in its finanical statements, analysts say, it isn't possible to assess the thrift's risk. Penny Dobkin, portfolio manager for Fidelity Management & Research Co., says she has stopped following Columbia as a result.

Nor are regulators completely satisfied. When Columbia recently asked the Federal Home Loan Bank Board for permission to add $100 million to net worth, the approval was conditional: Columbia would have to reduce its investment in corporate bonds to 10% of assets, which would have meant selling some $1.4 billion in such securities.

Federally chartered thrifts can't invest more than 10% of their assets in commercial loans, which would include junk bonds, but Columbia is a state-chartered institution and isn't subject to that restriction. "It was an arbitrary number. Regulators said they weren't concerned with our ability to do well. They said they were worried other thrifts would get involved without the same level of expertise," says Mr. Spiegel.

A spokesman for the Bank Board wouldn't comment on the matter. However, Eric Hemel, director of the Bank Board's office of policy and economic research, said a new regulation, which is expected soon, will upgrade the underwriting procedures required for a thrift investing in junk bonds.

While junk bonds have drawn all the attention, other aspects of Mr. Spiegel's strategy are unusual among thrifts as well.

Securities Sale Gains

Betting on a downward trend in interest rates, late last year Columbia began acquiring $1 billion in Government National Mortgage Association securities, which are government-insured. Gains from the sale of much of those securities are expected to account for about half the anticipated 1985 earnings increase. Mr. Spiegel concedes an unusually large amount of Columbia's earnings comes from such trades.

Mr. Spiegel already has sold $250 million in corporate bonds this year and may sell an additional $500 million.

Columbia also has attracted a large amount of deposits through brokerage firms—some $2.5 billion of its $4 billion total.

Regulators have been very critical of thrifts relying on such "brokered" deposits because brokers seeking high interest rates tend to move such funds more frequently among institutions than other types of savers. Some institutions have had liquidity problems because of the rapid withdrawal of brokered deposits.

Mr. Spiegel says Columbia has avoided that risk by stipulating that the deposits can't be withdrawn before the maturity dates which range from 1986 to 1987.

Mr. Spiegel is quick to point out that Columbia, which has only 16 branches and eight lending offices, also makes home loans. The thrift originated $200 million of mortgages in the first quarter and plans to originate between $600 million and $1 billion in mortgages this year.

But, Mr. Spiegel notes, the thrift has avoided making many construction loans. "You can only take so many risks," he says.

* * *

Mr. **Barnard**. Let me ask the second question of the three questions. Have brokered deposits been declining substantially as related to bank failures since 1983?

Mr. **Isaac**. I don't know what you mean by declining. We still are having a number of banks fail.

Mr. **Barnard**. Haven't the number of banks that are failing today because of brokered deposits—aren't those numbers declining?

Mr. **Isaac**. To date in 1985, we have had 11 banks fail with brokered funds in them, and we have had 55 failures to date, so that is 1 out of every 5 banks.

Mr. **Barnard**. Are you saying by that that the presence of those brokered funds caused those banks to fail?

Mr. **Isaac**. Not in every case. Certainly in some cases it did. If you look at schedule B attached to my testimony you will see six banks there where there is no question brokered deposits caused the bank to fail.

Mr. **Barnard**. Six banks?

Mr. **Isaac**. There are six examples given.

Mr. **Barnard**. Out of 55?

Mr. **Isaac**. Six out of the 80 in the schedule, but the list could be a lot longer. I limited it to six, for purposes of space. I wanted to show what is going with brokered funds, by way of example.

Mr. **Barnard**. Would you say then that the use of brokered funds is the most common way for problem banks to fail?

Mr. **Isaac**. No; I would say it is a common way, not the most common way.

Mr. **Barnard**. Don't a lot of the problem banks grow at the rate of 40 or 50 percent per year with other than brokered funds? I mean, we have got other ways to grow other than through brokered funds?

Mr. **Isaac**. Without access to fully insured brokered funds, it is very difficult for an institution to attract funds. Say you have a bank in Whartburg, TN. It is very difficult for a bank located in Whartburg, TN, to grow if they can't tap into these brokered funds supplied by credit unions and banks and S&L's.

They are going to have a lot of trouble growing at a 20- or 30-percent growth rate. If you let them tap into brokered funds, they can double or triple in size overnight.

Mr. **Barnard**. What happens to a bank when they advertise rather than go through a broker? Can't they secure great growth in deposits if they are paying an inordinately large interest rate—isn't that a way to grow as well?

Mr. **Isaac**. That is a way to grow, but it is difficult to do. Some banks try it and those banks get examined pretty regularly. It is a slower process.

If I run a $20 million bank, I can go out and buy $100 million in fully insured brokered funds tomorrow.

I can do that. If I want to try to advertise high rates, and do all this solicitation, I can also get some funds but it is going to be a million here and a million there. It is not going to be $100 million overnight.

There is no reason why a $20 million bank can't go out and arrange for $100 million in fully insured brokered funds tomorrow.

We will come down on it once we find it, but by then the money is gone.

Mr. Barnard. Mr. Isaac, in your prepared testimony are six case studies of failed banks that used brokered deposits. Weren't there other reasons that these banks failed than just because of poor credit judgment and incompetent management?

Mr. Isaac. I am sure they had incompetent or dishonest management in every case. It is hard for incompetent or dishonest management to do much harm if they don't have the money.

Mr. Barnard. In those cases, three involved linked financing, one involved bogus loans, one involved fraudulent insurance financing contracts, and one involved a worthless investment annuity contract.

Mr. Isaac. Right.

Mr. Barnard. What did you find in the way of linked financing?

Mr. Isaac. What do you mean?

Mr. Barnard. I mean what is linked financing?

Mr. Isaac. Well, to give you an example, in the Strongs Bank the brokered moneys were brought in and put out in bogus loans or linked loans, however you want to describe them, that were to interests of the insiders.

In the *Strongs* case, I would point out that there are also other brokered moneys that were enroute to the bank, but never made it. When they arrived at a correspondent bank, officials of the Strong's bank ordered the funds sent to another institution where they were diverted for the personal benefit of insiders.

Mr. Barnard. I guess the point I am trying to arrive at here is that seemingly we have labeled brokered deposits as a dangerous, dangerous practice for everybody, and said that they are primarily the reason for those bank failures. What I am trying to get into is that there are many other reasons for bank failures other than brokered deposits.

Mr. Isaac. Every bank that has failed to date has had incompetent or dishonest management. That is a given. I am not trying to downplay that as a cause of bank failures.

It is the principal cause. But it is hard for incompetent or dishonest management to cause very much damage if they don't have access to money. With fully insured brokered funds, we are letting incompetent, dishonest people write a blank check on the Federal Government.

Mr. Barnard. Because of the insurance fund?

Mr. Isaac. Because of the insurance fund, and I don't think that is what the insurance system ought to do. I don't think it can afford to let this practice continue.

Mr. Barnard. Mr. Selby, last February the Comptroller's Office reported in a letter to our subcommittee, the Commerce, Consumer, and Monetary Affairs Subcommittee, that most of the brokered deposits in troubled banks as of September 30 was in a few large national banks under the supervision of your office. This letter from Mr. Conover also reported that in this group of large problem banks, "we could uncover no example where brokered funds contributed to or exacerbated the problems that led to eventual downgrading of a bank's rating."

Does this mean that among the large national banks that you examined whatever trouble they are having would probably have occurred even if the FDIC's brokered funds proposal had been in effect, and the banks would have had easy access to other purchased funds on similar terms?

Mr. **Selby**. Yes. In most of the large banks, the retail brokered deposits are very small in relation to their total deposits, maybe 2 to 3 percent in some of the larger banks. These banks do have access to other funds.

Mr. **Barnard**. Could you describe for us in some detail, hopefully with a couple of concrete examples of open banks, of how the Comptroller's Office has dealt with brokered fund problem situations? Have you had any occasions to order any large, billion dollar institutions to reduce their brokered funds exposure, and if so, why?

Mr. **Selby**. As a rule we have put into our administrative actions on problem banks, including large banks, clauses requiring them to limit brokered deposits or to report to us more frequently on the level of brokered deposits.

In the larger banks, where brokered deposits amount to 2 or 3 percent of total deposits, I don't think brokered deposits necessarily contributed to their problems if they are indeed on the problem bank list. These banks obviously have funded themselves by retail deposits or by access to purchased funds. In their case, we are particularly concerned with their future funding ability and the use of volatile liabilities to fund their assets.

Mr. **Barnard**. In other words, if you had a problem bank that had a substantial loan commitment, would you recommend them to a broker?

Mr. **Selby**. If it was a problem bank, we wouldn't recommend it.

Mr. **Barnard**. In other words, you would rather them go to the discount window?

Mr. **Selby**. Yes. In 88 problem banks, we limited the solicitation of brokered deposits, and in eight we required the elimination of brokered deposits. I mentioned in my testimony three cases of failed banks in 1985 where we had reduced their reliance on insured brokered deposits.

Mr. **Barnard**. Mr. Isaac, I presume that you disagree with the Comptroller's Office that brokered funds abuses can be effectively controlled by supervisory methods; is that correct?

Mr. **Isaac**. Yes, I do.

Mr. **Barnard**. What have been the FDIC's losses specifically from brokered funds abuses in the national banks in the past 12 months, since July 1, 1984?

Mr. **Isaac**. I don't know.

Mr. **Barnard**. Aren't you all collecting that information?

Mr. **Isaac**. No. It is very difficult to gather it. You would have to make a determination as to what the losses are in a bank, which is difficult in a 12-month timeframe. After a bank fails it takes sometimes as long as 10 years to know what your losses actually are, No. 1.

Second, to decide how much of the loss was caused by brokered funds and how much by other sources is a very difficult process, so, no, we don't have that information.

Mr. **Barnard**. I was hoping that you did have that information because I then wanted you to respond as to whether or not the Comptroller's supervisory approach is inadequate. In other words, they have got just a very poor supervisory corps.

Mr. **Isaac**. This gives me a wonderful opportunity. There are so many things over the past 8 years that I want to get even with Mr. Selby for.

Mr. **Barnard**. We will ask him to respond to that when you get through.

Mr. **Isaac**. Let me say something about that, because I am really glad you asked the question. Except for the Comptroller's Office's position on the brokered deposits, which they seem to be coming around on a little bit, I want to commend the Comptroller's Office.

I think it is a first-rate regulator and is doing a good job. Our two agencies are working together more closely than ever before.

The coordination is good. The communication is outstanding. The quality of examinations and the strength and frequency of enforcement actions have all been enhanced, and I have no complaints except for a slight blind spot—I detected in their testimony today. That they are beginning to see the light—on brokered deposits.

Mr. **Barnard**. All right. Mr. Selby?

Mr. **Selby**. I agree with him.

Mr. **Isaac**. That you have a blind spot?

Mr. **Barnard**. In other words, you agree that you have seen the light; is that it?

Mr. **Selby**. I agree we are doing a much better job. How's that?

Mr. **Barnard**. Mr. Isaac, I guess the thing that concerns this member is data to support, you know, the premise that we need the legislation that you have suggested. We understand that the best current data on the volume of insured brokered deposits in banks is being collected monthly by the FDIC from all banks whose brokered deposits or insured deposits from other financial institutions exceeds 5 percent of the total deposits. Is that true?

Mr. **Isaac**. Well, that is one of the better sources, but even that——

Mr. **Barnard**. I don't want you to get far afield.

Mr. **Isaac**. I am not.

Mr. **Barnard**. Are you collecting that information?

Mr. **Isaac**. Yes, we are.

Mr. **Barnard**. All right.

Mr. **Isaac**. I want to put a word in——

Mr. **Barnard**. You can put a word after I put a word in. You are on that side of the table. You do collect this information?

Mr. **Isaac**. Yes.

Mr. **Barnard**. You know what the next question is, don't you?

Mr. **Isaac**. Yes. Go ahead.

Mr. **Barnard**. Why?

Mr. **Isaac**. Why do we gather it?

Mr. **Barnard**. No, why don't you make that information available?

Mr. **Isaac**. I will be happy to make it available.

Mr. **Barnard**. You haven't done it to the GAO?

Mr. ISAAC. We told the GAO we would provide that, but not a list of the problem bank list. We will provide a list of brokered funds coming into these institutions.

[In response to request of Congressman Barnard, the information was submitted for the record by Chairman Isaac and may be found on page 67.]

Mr. BARNARD. I guess we got some bad information. But what you are saying——

Mr. ISAAC. They have been told that they can have the actual reports filed by the banks showing their usage of brokered funds. They will get those. They are in our regional offices and we are gathering them now.

What they have been told they will not get is a list of the problem banks.

Mr. BARNARD. By name?

Mr. ISAAC. By name or any other way.

Mr. BARNARD. You wouldn't mind giving it to them by number, would you?

Mr. ISAAC. Yes.

Mr. BARNARD. What would be harmful about that?

Mr. ISAAC. If we gave a problem bank list by number and showed deposit sizes of the banks, I think they could probably figure out who a lot of the banks were.

Mr. BARNARD. Mr. Isaac, I must refer to your statement on page 9 having to do with the Government Operations Committee report of last fall on brokered deposits and the more recent staff analysis prepared by the committee.

You characterize these documents as "contending there is no problem despite overwhelming facts to the contrary." Let me just say as the chairman of that subcommittee, this is a total inaccurate characterization of the work of that subcommittee.

These reports acknowledge that there is clearly a problem of serious abusive practices in certain institutions, but what they do is question the need for or the effectivenss of the drastic measures proposed by the FDIC.

Frankly, you know, I think we are getting maybe closer to mutual understanding of this thing, but I just want to clarify the fact that we join you in your concern, I do, for the abuse of this practice. But I just sometimes think that we are trying to solve that problem with another law on the books that could be resolved with more supervisory—and I don't say better—regulatory process, but certainly through the regulatory process, the supervisory process

But, Mr. Chairman, I do say that this is a consideration that needs to be taken up as we take up deposit insurance reform. I think that we are all concerned about most of the insurance funds, and we certainly compliment the FDIC on the strength of its funds and the strong supervisory process that maintains it. But there again, though, we can see that there could be serious problems down the road both not only with the savings and loan industry, which we know we have to strengthen, but with the banking industry.

With that, I will close my testimony.

Chairman **Hubbard**. Congressman Barnard has said he will close his testimony?

Mr. **Barnard**. My testimony.

Chairman **Hubbard**. Thank you, Congressman Barnard.

Before we call on Congressman George Wortley, I would like to admit that I will have to leave the subcommittee hearing for about 40 minutes in order to rush over to the Senate side and try to testify at an oversight hearing on the Tennessee Valley Authority, which has several projects in my own district and their hearing ends at noon.

I regret this conflict and will ask Congressman Barnard to chair the subcommittee at this point.

Hopefully, after these two witnesses, we can continue with the list of witnesses without a break for lunch. After these two witneses we will ask for the 5-minute rule for our members with chances for repeat question times.

Congressman Wortley.

Mr. **Wortley**. Thank you, Mr. Chairman. Doug, you made up for the other eight members of the majority who are absent this morning, I will say that.

Chairman Issac, would the reduction of the $100,000 insurance ceiling to something like $50,000 or back to the $40,000 that it was a few years ago, achieve the objective of controlling brokered deposits?

Mr. **Isaac**. It would probably help to some degree, though we don't advocate it. I think it would be disruptive in the public's mind to have this insurance coverage rolled back. I think it would hurt public psychology. I wish we hadn't gone to $100,000. But now that we are there I think we are stuck with it.

Mr. **Wortley**. Was it the wisdom of the Congress to go to $100,000? How does the Comptroller feel about that? Would you recommend the lowering of that insurance ceiling?

Mr. **Selby**. No, I agree with Chairman Isaac. I think it would be disruptive. I don't know what our position was on raising coverage to $100,000, but I would not reduce it.

Mr. **Wortley**. In your testimony, on page 2, you refer to the fact that deposit brokering gives small institutions access to regional and national markets for deposits. Do you have any idea what percentage of these brokered funds are actually invested in the locality itself as opposed to these higher risk investments?

Mr. **Selby**. I do not have that figure.

Mr. **Wortley**. Is it a figure that might be available?

Mr. **Selby**. Are you asking the extent to which brokered deposits are invested locally by the larger institutions?

Mr. **Wortley**. Well, how much is put into local investment, business development and perhaps real estate or whatever else, rather than being put into higher risk investments, junk bonds and some of the other things that have been described here this morning?

Mr. **Selby**. It would be impossible to track that. All you could do would be to try to discern on the liability side where the money comes from and relate it to the portfolio of investments. I think it would be nearly impossible.

Mr. **Wortley**. Without getting into statistics, is it your best guess that most of that money is invested in high risk?

Mr. SELBY. I sincerely hope not. I don't think so.

Mr. WORTLEY. Chairman Isaac, on page 3 in your statement, you refer to a survey conducted by the FDIC last year which reveal over $9 billion in brokered funds being held by troubled institutions.

A study prepared by another subcommittee of the Congress claims that this $9 billion figure has no meaning or relevance as an indicator of the size of the brokered funds problem. Would you care to comment on that?

Mr. ISAAC. To the extent that the $9 billion is uninsured money, then it is not part of the problem, and right now we don't know what percentage of that $9 billion is insured and what is uninsured.

I said earlier today and I will repeat it, I would be surprised if we didn't find that the majority of that money was fully insured because it has been placed in troubled institutions and I don't believe those brokers are placing money in troubled institutions at their own risk or at the risk of their clients.

Mr. WORTLEY. How did you reach that figure of $9 billion?

Mr. ISAAC. It is what the banks reported.

Mr. WORTLEY. As broken out in their reports or in your——

Mr. ISAAC. They reported it.

Mr. WORTLEY. They do report it?

I yield back the balance of my time. I guess I have used up my 5 minutes, Mr. Chairman. I did better than you did, Doug.

Mr. ISAAC. Mr. Chairman, may I add one thing to the comment I made to Mr. Wortley? After the hearing that we had a month or two ago before a Senate subcommittee, one of the major brokerage houses, criticized me for characterizing three-, four-, and five-rated banks and thrifts as weak and risky institutions saying that a three-rated institution should be distinguished from a four- or five-rated institution and that a three-rated institution is actually an average institution.

I want to make sure that if this issue comes up at the continuation of this hearing today, the committee understands that a three-, four-, or five-rated institution is in roughly the lower 15 percentile of institutions. Where I went to school, we never learned that the lower 15 percentile was average.

Mr. WORTLEY. What is the average? In the one or the two category?

Mr. ISAAC. If you are a one or a two, you are considered a satisfactory or better institution. If you are rated three, it puts you mathematically in the lower 15 percentile, roughly.

A three-rated institution is considered in need of closer than usual supervision and is examined much more frequently. The Comptroller's Office considers a three-rated institution a problem institution.

We don't put a three-rated institution on our formal problem list, but it is considered a troubled institution that requires more than usual supervision. Four- or five-rated institutions, constituting 7 percent of the institutions in the country now, are considered to be formal problems.

Mr. WORTLEY. What is the frequency of your examination of three's, four's, and five's?

Mr. **Isaac**. The four's and five's would be visited roughly every 3 to 6 months. The three's would be visited roughly every 6 to 9 months. If you are a one- or two-rated institution depending on your size, you might get visited once every 3 or 4 years.

Mr. **Wortley**. I thank the chairman for the extension of time.

Mr. **Barnard** [presiding]. We want to thank both of you gentlemen for the testimony this morning. The interest of this subject always keeps us going over the allotted time.

Let me ask, following up George's question there, Mr. Selby, according to our information the OCC found that only 25 percent of the brokered funds that were in the problem banks were insured. Do you recall if that is an accurate statement?

Mr. **Selby**. Yes.

Mr. **Barnard**. Mr. Isaac, an FDIC survey this year found that less than $3 billion was insured.

Mr. **Isaac**. The survey that we did covered only institutions that had 5 percent or more in brokered funds. So let's say you are a $10 billion organization. You can have up to $500 million in brokered funds without having to report and you wouldn't be included in the survey.

So that is one reason why the $2.5 billion number we came up with in our survey this year is substantially lower than the $9 billion number we had last year.

Second, I don't trust the reports yet. I don't think we have good data. I was just asking Joe where he got the number that you asked about a few minutes ago.

Mr. **Selby**. It is from the call reports on retail brokered deposits.

Mr. **Isaac**. And those are not very reliable.

Mr. **Selby**. It is all we have, and we related those to the problem banks. It came up to 25 percent.

Mr. **Barnard**. Gentlemen, thank you for your testimony. It is always good to have you come before us. I continue to thank you for the great job that both of you are doing in your very heavy responsibilities.

Mr. **Selby**. Thank you.

[The following letters from Frank P. Smeal, general partner, Goldman, Sachs & Co., New York, NY, were received by the subcommittee for inclusion in the record:]

Goldman, Sachs & Co | 85 Broad Street | New York, New York 10004
Tel 212-902-1000

Goldman
Sachs

July 18, 1985

The Honorable Carroll Hubbard Jr., Chairman
Subcommittee on General Oversight and Investigation
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
Room B 304
Rayburn House Office Bldg.
Washington, D.C. 20515

Dear Chairman Hubbard:

I am a general partner and a member of the Management Committee of Goldman, Sachs & Co. and am in charge of its Fixed Income Department.

I understand that William Isaac, Chairman of the Federal Deposit Insurance Corporation, testified before your Subcommittee on July 16, 1985 concerning brokered deposits. As part of his testimony, Chairman Isaac repeated allegations he made during his testimony before the Senate Subcommittee on Financial Institutions to the effect that Goldman, Sachs & Co. acted as a broker for $80,000,000 of fully insured deposits.

When we first learned of Chairman Isaac's testimony before the Senate Subcommittee, we notified the FDIC staff by telephone that Goldman Sachs did not, and does not, act as a broker of fully insured deposits; that notification was given two weeks prior to Chairman Issac's testimony before your Subcommittee. On July 10, 1985, I also sent a letter to Senator Gorton, the Chairman of the Senate Subcommittee, to the same effect; a copy of that letter was sent to Chairman Isaac. I enclose a copy of that letter for your information.

In light of our efforts, we are mystified by Chairman Isaac's continued identification of Goldman Sachs as a deposit broker. I hope that he sees fit to withdrawal these false allegations publicly. In any event, we would be grateful if this letter and its enclosure were made part of any record of the proceedings of your Subcommittee. If you have any questions concerning Goldman Sachs or its role as a dealer in certificates of deposits, I would be happy to provide you with further details.

Very truly yours,

Frank P. Smeal

cc: The Honorable William M. Isaac

Goldman, Sachs & Co. | 85 Broad Street | New York, New York 10004
Tel 212-902-1000

Goldman
Sachs

July 10, 1985

The Honorable Slade Gorton
Chairman of the Subcommittee on Financial Institutions
Senate Committee on Housing, Banking and
Urban Affairs
Room 534
Senator Dirksen Office Building
Washington, D.C. 20510

Dear Senator Gorton:

I am a general partner and a member of the Management Committee of Goldman, Sachs & Co. and am in charge of its Fixed Income Department.

I understand that William Isaacs, the chairman of the Federal Deposit Insurance Corporation, testified before your Subcommittee on June 6, 1985 concerning so-called "brokered deposits". In the course of his testimony, he identified Goldman, Sachs & Co. as one of a number of firms which he alleged engaged in brokering deposits which were fully insured by the FDIC; in the case of Goldman, Sachs & Co., he asserted that we acted as a broker for $80,000,000 of such deposits. Goldman, Sachs & Co. does not engage in the practices alleged by Chairman Isaacs, and I am writing to clarify the record.

Chairman Isaacs testified that certain firms bought certificates of deposit on behalf of customers. These certificates of deposit were issued by banks which were rated by the FDIC as financially troubled;[1] in order that the deposits were fully insured by FDIC, each certificate was then broken up by the broker into deposits of $100,000 or less for each customer. Chairman Isaacs believed that such practices were unwise and put the FDIC's insurance fund unduly at risk.

Regardless of the merits of Chairman Isaacs' views on the such activities, Goldman, Sachs & Co. simply does not engage in them. Goldman Sachs is a major broker/dealer in a wide variety of money market instruments; it is, for example, one of thirty six primary dealers who transact business directly with the Federal Reserve Bank of New York. Bank certificates of deposits are among the instruments in which Goldman Sachs deals. Because the FDIC refuses to advise Goldman Sachs of which banks identified Goldman Sachs as a broker of their deposits, it is impossible for us to determine whether we even purchased certificate of deposits of any such banks. However, assuming that we did so, the amount of any such certificate would have been well in excess of $100,000 and almost certainly in excess of $1,000,000, and any certificates we sold would have been in the same size. We specifically did not and do not break up certificates of deposits into smaller pieces in order that customers benefit from full FDIC insurance. Because the size of the certificates of deposits bought and sold by us were far in excess of the FDIC limits, it is simply incorrect to assert that Goldman Sachs was brokering deposits fully insured by the FDIC. We believe that Goldman Sachs' activities contribute to the financial stability of banks by providing them with a deposit base without unduly affecting FDIC's insurance fund.

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[1] The FDIC identified banks which were rated 3, 4 or 5 on its reporting system as financially troubled; that methodology is curious in view of the fact that the failure of a bank with a "3" rating is, according to FDIC's rating system, "only a remote possibility". The FDIC does not publicly disclose its ratings of banks.

I find it extremely troubling that Goldman Sachs was falsely accused by the Chairman of a federal regulatory agency of engaging in practices which he believed encouraged unsafe banking practices and exposed the bank insurance fund to undue risk. Such an allegation is particularly objectionable, because it was made without any prior consultation by the FDIC with Goldman Sachs. Indeed we first became aware of such charges when we read them in the financial press.

I trust that this letter has made clear that Goldman Sachs has not engaged in the practices of which Chairman Isaacs complained. We would be grateful if this letter was made part of any record of the proceedings of Subcommittee. If you have any questions concerning Goldman Sachs or its role as a dealer in certificates of deposit, I would be happy to provide you with further details.

Very truly yours,

Frank P. Smeal

cc: The Honorable William M. Isaacs ✓

Mr. **Barnard.** Our next witness this morning is a very attractive and very capable executive staff director and Chief of Staff of the Federal Home Loan Bank Board. We are certainly privileged this morning to have Mrs. Shannon Fairbanks. It is so nice to have you with us this morning, Mrs. Fairbanks.

STATEMENT OF SHANNON FAIRBANKS, EXECUTIVE STAFF DIRECTOR AND CHIEF OF STAFF, ON BEHALF OF THE FEDERAL HOME LOAN BANK BOARD

Mrs. **Fairbanks.** Thank you very much.

Are we permitted to call you Mr. Chairman here?

Mr. **Barnard.** I guess so inasmuch as I am substituting for someone else this morning.

Without objection your entire testimony will be included in the record if you care to summarize.

Mrs. **Fairbanks.** Thank you very much. I am delighted to be here—delighted to appear before you and the distinguished members of the subcommittee.

On behalf of the Federal Home Loan Bank Board, I am pleased to present our views on the use of brokered funds by FSLIC-insured institutions.

The concerns of the Bank Board regarding brokered funds dates back to the fall of 1983 when it became clear that their growing use by savings institutions was out of control. One of the main reasons for alarm at the time was that the unlimited use of federally insured third party brokered deposits was fueling skyrocketing asset growth, and that failure is derived in large part from bad assets.

When an institution fails and bad assets are involved the cost to the FSLIC to resolve that case is far greater than in cases where the cause of insolvency results from earnings problems.

Three years ago, roughly 80 percent of FSLIC cases were primarily caused by interest-rate spread problems, while 20 percent of supervisory cases at the Federal Home Loan Bank Board were due primarily to bad assets. Today, as of December 1984, 70 percent of such cases are asset quality problems. As you know, the Bank Board joined with the FDIC in a concurrent rulemaking process to deal with the brokered funds problem, and both agencies adopted a final regulation in March 1984.

However, the Federal judiciary determined that both agencies had exceeded their statutory authority in adopting the regulation.

The Bank Board, on two separate occasions, has asked the Congress for authority to classify insurance of accounts. These requests took the form of proposed legislation which was introduced by request last year in both Houses and again, this year, by Chairmen Garn and St Germain.

The ability to classify insurance of accounts would provide the Bank Board, in its capacity as operating head of the FSLIC, the flexibility to deal effectively with brokered funds problem. As of December 1984—and our problem I might add is large—as of December 1984 our institutions held $43 billion in brokered funds with 81 percent—or nearly $35 billion—estimated to be insured. Of that amount, about $22 billion was held in troubled institutions.

You, the Members of Congress, have assigned the members of the Federal Home Loan Bank Board certain duties to insure the safety and soundness of these saving institutions, to encourage and support the environment for economical home finance, and to make certain that the limited resources of the Federal Savings and Loan Insurance Corporation are used in the most efficient manner.

In these duties they face the legacy of interest rate deregulation that occurred during a prolonged period of high interest rates. All the interest rate spread cases have not yet been disposed of by the FSLIC, but today we are facing a burgeoning caseload of asset quality problem cases which are tremendously difficult to deal with and which involve potentially enormous costs.

In this environment it makes absolute sense to avoid the avoidable FSLIC case. There are three axioms to consider when dealing with brokered funds. First, brokered funds can allow for growth far in excess of the limit implied by local retail markets.

Second, rapid growth can lead to a deterioration in overall asset quality if the institution stretches for yield, invests in higher risk local projects, or invests outside its normal lending territory.

Third, asset cases are far more expensive for the FSLIC to resolve than interest rate spread cases. While brokered funds are not per se objectionable, I can tell you that the Bank Board, as head of FSLIC, has had to confront a number of settlements where brokered funds were implicated in the failures and posed enormous costs to the FSLIC.

Indeed, today over 50 percent of the most troublesome of the FSLIC's current problem cases involve high levels of brokered funds. As I noted before, there is currently about $22 billion held by our problem institutions having the CAMEL-type ratings of three, four, and five that Bill Isaac referred to.

As the following statements demonstrate, the Bank Board cease and desist enforcement actions and emergency enforcement actions have been used against insured institutions involving brokered deposits, but only after the institution had severe problems threatening its safety and soundness.

C&D issued: 11/8/82, brokered funds, 8.7 percent of deposits. C&D issued: 8/6/82, brokered funds, 42 percent of deposits. C&D issued: 6/22/83, brokered funds, 57 percent of deposits. C&D issued: 8/19/83, brokered funds, 45.1 percent of deposits. C&D issued: 8/14/83, brokered funds 38 percent of deposits. C&D issued: 1/6/83, brokered funds, 66 percent of deposits. C&D issued: 2/2/84, brokered funds 28.4 percent of deposits. C&D issued: 2/22/84, brokered funds, 60 percent of deposits.

Mr. **Barnard**. What is this C&D?

Mrs. **Fairbanks**. A cease-and-desist order. I will be happy to discuss it later. We find our ability to issue C&D enforcement actions severely constrained. The most recent egregious example of the abuse of brokered funds is Beverly Hills Savings & Loan Association, the largest receivership in S&L history.

A fellow committee is currently reviewing in some detail the facts behind that failure. Since 1982, this institution experienced record growth. Its assets at yearend 1982 were $952 million. Assets increased to $1.9 billion at the yearend 1983 and to $2.9 billion at the yearend 1984.

This 2-year growth of 205 percent was fueled by brokered deposits. Congressman Parris earlier raised the issue of the use of the examination process. I would note to you that the case of Beverly Hills highlights the inherent limitations in the use of the examination process to curb abuses of brokered funds.

The examination process is after the fact. It reveals what has already been done. Once an association has made a terrible investment it can, ideally, identify that fact. But the association and the FSLIC are stuck with the loss.

For example, Beverly Hills assets grew by approximately $141 million, roughly during the 2 months that the 1983 examination was ongoing. Let me repeat that.

Beverly Hills assets grew by approximately $141 million during the 2-month process of the 1983 exam. If the examiner is able to identify poor quality assets, for which the association's auditors have not required writedowns, he normally cannot simply direct the association to establish appropriate loss reserves because reappraisals are required before the association can be directed to establish loss reserves.

The examiner depends upon the district appraiser to confirm that the original appraisal is suspect. The district appraiser has to obtain reappraisals from independent appraisers. That often takes 3 or more months. Even when a reappraisal comes back and the supervisor directs the creation of a loss reserve, the association may refuse to do so, claiming that the reappraisal is in error.

The loss reserves ordered by the supervisory agent may render the association insolvent and make it subject to the appointment of a receiver, so the association has a tremendous incentive to question the appraisal.

In addition to the inherent limitations of the examination and supervision process to curb brokered fund abuses, there are unnecessary limitations the Congress should consider removing.

The Bank Board has proposed legislation to expand its power to issue immediate cease-and-desist orders when the books and records of our association are so incomplete or inaccurate that the agency cannot determine there financial condition of the institution.

We seek your help to get that now pending legislation passed. The Board's recent experience is that the net cost to resolve FSLIC cases where asset problems were the case of failure runs to about 25 cents on the dollar.

My question is, what conceivable public benefit can balance the multihundred-million-dollar cost of resolving the San Marinos, the Empires, and now of resolving Beverly Hills, among others, all of which resulted from brokered deposits.

Thank you. I will be happy to answer any questions.

[The following statement of Hon. Edwin J. Gray, Chairman, Federal Home Loan Bank Board, was submitted by Mrs. Fairbanks for inclusion in the record:]

STATEMENT OF
EDWIN J. GRAY, CHAIRMAN
FEDERAL HOME LOAN BANK BOARD
BEFORE THE SUBCOMMITTEE ON GENERAL OVERSIGHT
AND INVESTIGATIONS
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES
JULY 16, 1985

Mr. Chairman and distinguished members of the Subcommittee:

On behalf of the Federal Home Loan Bank Board, I am pleased to once again present my views on the use of brokered funds by FSLIC-insured institutions.

My concerns regarding brokered funds date back to the fall of 1983 when it became clear to me that their growing use by savings institutions was out of control, and that they were the single most important factor in a rising number of thrift institution failures.

One of the main reasons for my alarm at the time was that the unlimited use of federally-insured, third-party brokered deposits was fueling skyrocketing asset growth, and that the failures we were beginning to see at the time derived in large part from bad assets. When an institution fails and bad assets are involved, the cost to the FSLIC to resolve such cases is far greater than in cases where the cause of insolvency results from earnings spread problems.

As you know, the Bank Board joined with the FDIC in a concurrent rulemaking process to deal with the brokered funds problem and both agencies adopted a final regulation in March of 1984 which I continue to believe was crafted to appropriately deal with the problem.

However, the federal judiciary determined that both agencies had exceeded their statutory authority in adopting the regulation.

The Bank Board on two separate occasions has asked the Congress for authority to classify insurance of accounts. These requests took the form of proposed legislation which was introduced by request last year in both houses and again, this year, has been introduced by request by Chairmen Garn and St Germain.

The ability to classify insurance of accounts would provide the Bank Board, in its capacity as operating head of the FSLIC, the flexibility to deal effectively with the brokered funds problem.

I recognize there are very powerful financial forces in the lobbying community -- some investment banking houses and other money brokering operations -- which have sought to prevail on members of the Congress in their own corporate interest and, frankly, against the interests of a safe and sound federal deposit insurance system.

Employing their powerful financial might in an effort to run roughshod over the deep concerns of those of us who, as surrogates for the Congress, are mandated by law to manage and protect the reserves of the federal deposit insurance system, they have succeeded in at least muddying the waters and successfully leaving the impression in some quarters that brokered funds have played no possible role in the failures we have encountered.

Indeed, these money brokering operations have sought to leave the impression in too many instances that such money brokerage has wrought no harm on the deposit insurance system at all. Those at fault, they say, were not the money brokers but rather insured institutions which invested the funds poorly. The money brokers and the brokered funds, they claim, were simply innocent bystanders, harmless participants in the death dance of failed and failing institutions.

Those who believe such stories are likely to believe in fairy tales.

The fact is, in far too many cases, it was the easy, instantaneous access to very willing money brokers, willing to provide high-priced federally-insured money to any institution which sought it, in virtually unlimited amounts, which fueled the rapidly made investments and loans that have turned out as very bad assets in some of the most significant thrift failures we have seen.

Who was left to pick up the pieces? Your federal deposit insurance system.

I know there are those who don't appreciate hearing what I have just said, but so far as I'm concerned it's the simple truth of the matter.

And, in all honesty, it has increased the strains on your federal deposit insurance system for savings institutions.

I need only cite a few failures to illustrate the egregious involvement of brokered funds in failed and very troubled FSLIC-insured institutions.

The first institution I will cite had 1982 year-end assets of $820 million. Assets more than doubled, to $1.90 billion, in the following year and shot up to almost $3 billion by the end of 1984. This 262 percent growth in assets in just two years was fueled largely by brokered deposits. These brokered funds reached a level of a billion dollars in the institution and much of the $2.1 billion growth it fed was in high-risk investments, primarily construction loans and real estate investments. Nonearning assets totalled $720 million by the end of 1984 driving the institution into insolvency.

Perhaps the most widely recognized case of brokered funds was that of Empire Savings and Loan Association of Mesquite, Texas. This state chartered, federally-insured savings institution grew exceedingly fast in a period of two years, and then collapsed under the weight of what we believe were reckless and fraudulent practices. In March 1982, Empire had only $20.7 million in assets, $5.7 million in "jumbo" certificates of deposits, and $8.3 million in outstanding construction loans. By January 1983, Empire had grown to $117 million in assets, $88 million in jumbo CDs, and $50 million in construction loans outstanding. These figures virtually exploded by January 1984, when Empire's assets had grown to $320 million. At the time Empire was placed into receivership in March 1984, brokered deposits of $262 million represented some 85% of total deposits. The skyrocketing growth which led to ultimate disaster for the institution and the FSLIC was fueled in great part by high-priced brokered funds which financed fraudulent real estate transactions and speculative construction in massive amounts.

In another failure, that of San Marino Savings in California, the institution grew from $24 million in assets as of December 31, 1981 to $681 million by year end 1983. The association relied to a large extent on brokered funds to achieve its astronomical rate of growth. The June 1983 semi-annual report reflected that over 50% of savings were originated by money brokers. When the institution was placed into a conservatorship in February 1984, $168 million in brokered funds represented some 43.1% of total deposits. The institution made major construction loans and financed investor-owned condominium conversion units which are considered to be high risk activities. This failure will be very expensive to the FSLIC when all the bills are finally paid.

Over 50 percent of the most troublesome of the FSLIC's current problem cases involve high levels of brokered funds.

Here are some examples:

An institution doubled in size by taking in high-rate brokered deposits and the funds were expended in improperly documented and risky loans which resulted in heavy losses. Internal controls were woefully inadequate.

An institution, which virtually doubled in size in a very short time, employed high-rate brokered money to fund development projects. Appraisals were based on "land-flips" and consequently exaggerated the value of the collateral by several times its actual worth.

Another institution saw growth as a key to restructuring a low-yield portfolio. Brokered deposits funded a rapid quadrupling in size. The high risk assets acquired with the brokered funds turned out to be big losers for the association and, ultimately, for the FSLIC.

Yet another institution became involved in a "linked" financing arrangement with a deposit broker. Not only did the broker deliver high rate deposits, he provided uses for the funds in the form of speculative loans to real estate development projects across the country. When the developers defaulted on the loans, the association was left with the greatly overvalued collateral and, therefore, huge losses.

The stories become very repetitive. Brokered funds are easy to come by, so very, very easy. The risk of loss associated with the high rate of return on the acquired assets -- which have been so often fueled by brokered funds -- has all too often turned into actual losses, huge losses. In the final analysis, the risks so often fueled by instant access to high levels of brokered deposits are borne not by management or by owners, but by the FSLIC.

In these failures, and others, as well as other yet unresolved and very difficult cases still before us, the easy access to, and very heavy use, of high-priced federally-insured brokered funds did not occur in a vacuum nor could it have been accompanied by purely innocent naivete on the part of the money brokers. To suggest that this kind of money supply operation was, or is, the equivalent of a simple service performed by request, and nothing more, ignores the aggressive marketing of such funds to thrift institutions by money brokers in general. The money brokers were, and are, always held harmless from any risk of loss. The funds were, and are, guaranteed by the FSLIC, and the losses these institutions suffer are borne by the FSLIC.

Fortunately, the efforts made by the FDIC and the Bank Board to rein in these activities -- even though the concurrent regulation which was adopted by both agencies was ultimately ruled inoperative by the courts -- did have a somewhat chilling effect on money brokering.

Still, the heart of the problem and its potential for further mischief continues. And, that is why I want to take this opportunity once again to urge the Congress to provide to those of us who are asked to manage these deposit insurance funds the flexibility we need to deal effectively with federally-insured money brokering by enabling us to classify insurance of accounts.

There are those -- particularly in the third-party money brokerage industry -- who would have you believe that the main purpose of federal deposit insurance is to insure accounts. They choose to make that erroneous argument frequently because it serves their own purposes. For if it could be successfully argued that insurance of accounts was the main reason for federal deposit insurance then it might logically be argued that such insurance ought not to be the sole province of depository institutions.

Federal deposit insurance in this country evolved principally as a Congressional response to a series of crises dating back to 1864, 1907, and ultimately to the great depression of the 1930s. The early years of that depression proved that other mechanisms which had been used to maintain stability and prevent loss of depositor confidence were not working.

The financial panic of the early 30s made this clear. Massive runs on banks, indeed the virtual collapse of the banking system, prompted President Roosevelt to proclaim a bank holiday during which all financial institutions suspended operations.

The emergency produced the Banking Act of 1933. This legislation began the process of restoring public confidence in depository institutions by, first, requiring all federally chartered banks to become members of the newly-created FDIC. Subsequently, the Congress passed the National Housing Act of 1934 which established the FSLIC.

President Roosevelt summed up his May 14, 1934, message to the Congress urging passage of the legislation which established the FSLIC in these words:

"These (savings) institutions are custodians of funds for small savers, and it is essential that they should be given every protection. Insurance of this type is necessary in order to arrest any further drain on these institutions and to put them in a position to resume their normal operations."

These concerns were echoed by members of Congress and the then-General Counsel of the Federal Home Loan Bank Board, Horace Russell. In January, 1934, he stated:

"The object to be accomplished by the suggested insurance of savings and loan shares is primarily to stabilize confidence in home financing institutions and thereby attract savings in this direction..."

The fact is, fifty years ago, the Congress specifically assigned to our savings institutions and banks the custodianship of federal deposit insurance. Such insurance has never, ever -- either implicitly or explicitly -- been assigned to any other kind of financial organization by the Congress.

Through the decades which have come and gone since then, depository institutions have accepted their responsibilities as regulated institutions to serve the deposit and lending needs of working men and women, families, the elderly and the young in their communities -- backed by the federal deposit insurance system, which, again, has served to maintain public confidence in the safety and stability of our depository institutions.

Indeed, several years ago, when interest rates reached historic highs and when a chorus of fears echoed through the halls of Congress that there might be panic-generated depositor runs on troubled thrift institutions and banks, the Congress, in overwhelming concurrence, declared by resolution that the "full faith and credit" of the United States would stand behind the federal deposit insurance funds.

While the nature of the action was different, the purpose was the same as that of a Congress a half century earlier -- to reinforce once again public confidence in the stability of our depository institutions as safe havens for the deposits of small savers.

I want to make it very clear that I have no problem whatsoever with money brokering, as such. It is the use of federal deposit insurance to guarantee funds which can be instantaneously accessed by still healthy or relatively healthy institutions and then invested, with no knowledge whatsoever by the regulator, in endeavors which may quickly turn very sour, get the insured institutions into deep trouble fairly rapidly, and cause the bill to the FSLIC for the funeral to be sky-high, which concerns me.

The Bank Board's concerns about money brokering funds to thrift institutions are not new. They go back many years. Indeed, it was only in 1980 that the Bank Board removed the limits on the amount of brokered funds a thrift could take.

Until that time, FSLIC-insured institutions were limited to five percent of deposits in such brokered monies. Indeed, the main reason why the Bank Board took off the five percent limit in 1980 was because the primary concern -- the siphoning of funds in 1959 to invest in California institutions at an advantageous differential -- no longer existed. At that time, federally-insured thrifts were losing deposits to money market mutual funds which were able to pay higher interest because they, unlike depositories, were not subject to federally-imposed rate controls. The attempt to slow the disintermediation which was occurring at the time in many thrift institutions prompted the removal of the five percent-of-deposits limit on brokered funds.

That was understandable, perhaps, under the circumstances. Those circumstances don't really exist today in the thrift industry, and for a number of reasons.

First, the rate control environment which existed then has long since gone. Today, thrifts and banks can pay any rates they choose for funds. There is no lack of liquidity in the industry.

Second, the Bank Board has been operating for a year now with a regulation which limits brokered funds to five percent of deposits for savings institutions which fail to meet a snapshot three percent net worth level, unless waived by the Bank Board in a particular case for very good cause.

Third, in January, the Bank Board adopted a new regulation which far more closely correlates asset growth to net worth and will have, we believe, the effect of substantially slowing new asset growth, especially in the absence of commensurate earnings on that growth.

However, the new net worth regulation must be reviewed within its two year sunset period and it is important that the Board have the flexibility to consider not only the amount but the type of deposit growth undertaken by an insured institution.

What we need today at the Bank Board is the ability to better manage the risk of loss to the FSLIC. What we need is additional flexibility to do so. What we need is the kind of discretionary elbow room which would allow us to classify insurance of accounts and to place the kind of limits we believe are appropriate to protect the safety and soundness of our insurance fund.

This issue goes beyond just the brokered funds issue. Hasn't the time come for the Congress to reaffirm that the real purpose of the insurance system is to protect the small, relatively unsophisticated saver and to assure that saver's confidence in the financial system; that the insurance of an account is an agency function -- not a wide open playing field subject to twisting and bending by huge, sophisticated or clever financial giants.

The reason the Bank Board worked so closely with the FDIC in moving forward the concurrent regulation on brokered funds last year was because we felt then, and I still believe, thrifts and banks ought to be treated in the very same manner with respect to federally-insured third party money brokering.

I continue to believe that so far as third-party money brokering of federally-insured accounts is concerned, all banks and thrifts ought to be treated in the same way and that the FDIC and FSLIC should govern through regulatory discretion under law the manner in which these same kinds of insured accounts are treated.

Both the FDIC and the FSLIC currently have the ability to set percentage limits on the share of insured brokered funds institutions they regulate can accept. At the FSLIC, that would include all FSLIC-insured institutions. At the FDIC, it would only include those state-chartered non-Federal Reserve member banks which the FDIC also regulates. This would not include Federal Reserve member banks and national banks because their primary regulators would not be subject to any such FDIC-established percentage limits.

Hence, in my view, the need to permit the FDIC and FSLIC to establish such percentage limits they may deem to be appropriate, given the responsibilities of these federal insurance corporations to safeguard the resources of their funds. Again, the best way to accomplish the objective of flexibility for both of these deposit insurance funds is to legislatively provide us the ability to classify insurance of accounts.

This ability would allow us to deal not just with brokered accounts issues but with others that we are beginning to see. For example some institutions recently began issuing accounts the return on which is tied to the return on an equal investment by the insured institution in pools of real estate investments.

While the Board dealt with that issue on a regulatory basis to define the difference between an insured account and a real estate investment -- which FSLIC was never intended to insure -- ingenious minds are continuing to generate new proposals seeking to clothe various kinds of securities and risk investments with the backing of federal deposit insurance. Providing the FSLIC explicit statutory authority to determine what kinds of accounts are insured, and what kinds are not insured, would enable the Bank Board to bring clarity and sanity to this area.

The next best way would be to impose a five percent limit, as a percentage of total insured deposits, on all third-party, federally-insured brokered funds placed at any federally-insured depository. I would permit the insurance corporations the discretion to allow an institution to exceed that limit only in very exceptional cases where, in the insurer's view, the national interest would justify it.

In my view, legislatively determining what is an appropriate maturity for any money-brokering, insured certificate of deposit would undercut what I believe ought to be properly left to the discretion of the appropriate insurance corporation.

I want to return here to an earlier concern I expressed: that an intense lobbying effort by a powerful money broker industry lobby intent on causing explicit legislation to be passed governing the exact manner in which the Presidentially-nominated and Senate-confirmed boards of governors of the FDIC and FSLIC are to treat federally-insured brokered funds, would, if successful, simply undercut the discretion and flexibility we need to manage for safety and soundness the resources of, and respond to changing circumstances of, these insurance funds.

What we need, I believe, is the support of the Congress in our efforts to safeguard the reserves of the insurance funds under different, changing and, yes, sometimes difficult circumstances. And, of course, we need and fully expect the continuing oversight of the Congress with respect to the manner in which we carry out our duties under the law.

None of this, however, is meant to suggest in any way that the Congress should act or legislate in any way other than that which it deems appropriate. The Congress of the United States, with the President, is charged with the responsibility for making national policy. Our job is to carry out national policy and that we try very hard to do.

Regulating for safety and soundness to safeguard the resources of our federal deposit insurance funds is not easy. It demands judgment and flexibility as provided under law. It also demands integrity, firmness and a full-fledged commitment to uphold the spirit and intent of the law.

I believe this is the principal reason why the Congress has established the "independence" of the federal deposit insurance agencies. This independence serves, and has served, this nation very well for a long time now. We are not interested in protecting the corporate self interest of any lobbying giant when it comes to the federal deposit insurance system.

We are deeply interested in, and we are committed to the task, of protecting and safeguarding the safety and soundness of our deposit and insurance system and the reserves of the system, on your behalf, in behalf of the American public, and in the interest of a sound and stable depository institutions system in our country.

Needed flexibility under the law to accomplish these objectives is what I believe we need, and it is my hope the Congress will agree.

Thank you very much. I will be happy to try to answer any questions members of the Subcommittee may have.

Mr. **Barnard**. Thank you very much, and you enumerated the example of Beverly Hills. What was that growth again that they experienced in the last few months?

Mrs. **Fairbanks**. The growth that I was referring to was the growth that occurred while our examiners were on site. The point I was trying to make was that $141 million came in by brokered means while our examiners were on site for 2 months during the 1983 exam process.

Mr. **Barnard**. What was that total growth, though?

Mrs. **Fairbanks**. Let me give you some of the figures. I think the point I am trying to make is that the kind of explosive growth that was occurring at Beverly Hills—its assets at yearend 1982 were $280 million. Assets increased to $1.9 billion at yearend 1983, to $2.9 billion at yearend 1984.

It was a 2-year growth of 262 percent, and that growth was fueled primarily by brokered deposits. Brokered deposits continued to grow, reaching over $1 billion in January of this year. We had imposed a ceiling on Beverly Hills which it ignored and continued to bring in brokered funds.

Mr. **Barnard**. Let me ask you this question. Wasn't Beverly Hills also acquiring an unusual amount of funds because of high interest rates that they were paying on their deposits.

Mrs. **Fairbanks**. Absolutely. I think that——

Mr. **Barnard**. A lot of it came in because of those high rates, other than just brokered deposits?

Mrs. **Fairbanks**. The brokered deposits came in because of the high rates. I would say that there is probably a conflict here between two things: the desire of the broker, on the one hand to get the highest yield available for his customer, and on the other hand, the responsibility of the bank board to maintain some kind of sensible control over what is happening at institutions, and I think that Bill Isaac raised a point earlier that is well taken.

When you have a Federal deposit insurance underwritten base and you have on top of that a number of managers who are going to take opportunities available to them, one of the things as a regulator that you have to be very careful about is the piece at the margin that is going to balance your system. I guess if I were to look at the entire universe of assets within both the commercial banking and the thrift industry, the majority of those are sound and the majority of those managers are sensible, but we have a number of things on our side of the equation which, given our ability to move, make it absolutely incendiary when you add in the potential for the unknown—the search for funds at high rates by offshore people that we don't control.

Mr. **Barnard**. The reports that the Home Loan Bank Board is getting monthly, don't they pretty well establish what institutions are paying inordinate rates and also what the amount of brokered deposits that come into those institutions is?

Mrs. **Fairbanks**. First of all, our major reporting system for nonsupervisory cases, the ones we are most concerned about at this stage, is for those institutions that are going to, for whatever reason, decide to engage in search for high cost funds and move them into very high risk investments to get adequate returns.

Those institutions which are now healthy are the ones that pose our greatest danger because we look at——

Mr. **Barnard.** But you do get these reports.

Mrs. **Fairbanks.** The issue I am trying to raise is that the time lag in reports is, No. 1, a problem.

Mr. **Barnard.** What is the timelag, 30 days?

Mrs. **Fairbanks.** Associations are supposed to file monthy reports 10 days after the end of the month. It takes several more days in Washington to edit and enter the data in the computer. Noncompliance with these timeframes and the error rate for problem associations is high, although followup is forceful. For example, we can and have sent examiners in to do monthly reports and bill tardy associations. Thus, timelap of 2 weeks or even more before reported data is in an available form are not unusual.

Mr. **Barnard.** Would you guess that—is the time delay 6 months or less?

Mrs. **Fairbanks.** No, it is certainly less than 6 months. But I will say that we have reporting problems in certain institutions which delay signals to us that we ought to start to be concerned.

Mr. **Barnard.** I guess the question I am raising at this hearing, which you and I and Chairman Gray have talked about in the past, is whether the information that is coming in is not adequate to red flag certain institutions that should have immediate and close supervisory attention.

Mrs. **Fairbanks.** We are finding that there is no question that there are institutions that over short periods of time take actions to secure large amounts of funds in a way that is not known to us. When an institution chooses to pull in $400 million in 3 months, we may finally find out about it 30, 40, or 60 days later.

We then start to move in response to this knowledge, and that is also a problem. We have to prove substantial dissipation of assets before we can take action against an institution. We can't look at an institution and say per se whatever they are doing is wrong.

Mr. **Barnard.** You need more legislative authority as far as cease and desist is concerned?

Mrs. **Fairbanks.** We have sought more legislation, yes.

Mr. **Barnard.** What has been your experience since March of this year with your 25-percent annual growth rule? Wouldn't that assist in correcting some of the large growth due to brokered deposits?

Mrs. **Fairbanks.** In response to both that question and the question you asked Mr. Isaac, I think that there has been a slowdown in the absolute amount and percentage of use of brokered funds. I think we are seeing in our most recent data, which is preliminary, that there has been a slowing of the growth line that was occuring. I think that has occurred for several reasons, some of them actions we have taken, and some of them a general sense of unease on the part of consumers who aren't sure what is going to happen.

I do think that there is still a very deep and serious problem, Mr. Chairman, because no matter how substantially the trend line has started to come down, we are faced with losses against the fund—a record loss in the case of Beverly Hills. Again, we are talking about something occurring at the margin in a system that is unable to bear that kind of unscrutinized growth over short periods of time without some kind of real controls, and our controls after the fact don't take care of it.

Mr. Barnard. Let me ask you a final question on Beverly Hills. From what I have read, and the results of the hearing that is now taking place in another committee in the House, wouldn't Beverly Hills have failed anyway, without brokered deposits?

Mrs. Fairbanks. That is hard to say, but it is certain that a major problem at Beverly Hills was imprudent growth fueled by brokered deposits. The following figures illustrate the growth of brokered deposits at Beverly Hills from December 1982 to January 1985.

	Dollar amounts in millions	Percent of total savings
Date		
December 31, 1982	$89	14
October 31, 1983	264	20
December 31, 1983	661	45
April 30, 1984	841	49
June 30, 1984	790	45
July 31, 1984	859	46
November 31, 1984	937	42
January 1, 1985	1,100	43

As these figures illustrate, in late 1983 Beverly Hills began to rely heavily on brokered deposits, and this trend accelerated throughout 1984. These funds were used to fund many of Beverly Hill's questionable investments.

Mr. Barnard. I think the findings are going to be the losses at Beverly Hills were exacerbated.

Mrs. Fairbanks. No question.

Mr. Barnard. But it didn't in itself cause the failure.

Mrs. Fairbanks. No, sir, but in every one of these cases the loss itself has been significantly increased by the direct use of access to funds that are then put into bad investments. There is a close correlation of paying high rates, securing fast funds, and then moving them into high risk, potentially high yield investments.

Mr. Barnard. Mr. Parris.

Mr. Parris. Thank you, Mr. Chairman.

Mrs. Fairbanks, just to follow up on a question. There is no question in your mind, is there, that the Beverly Hills S&L growth that you outlined was directly related to the higher than market interest rate that was being paid for deposits; isn't that true?

Mrs. Fairbanks. Absolutely.

Mr. Parris. These brokers simply chased the highest rates in the Nation.

Mrs. Fairbanks. And there is no reason why the brokers shouldn't do that under existing law.

Mr. Parris. That is called the American system. If you can get 12 percent at Beverly Hills and 11 percent in northern Virginia, go to Beverly Hills. Pick up the telephone, one secretary in a small office with one desk, you can go into business tomorrow like that, right?

Mrs. FAIRBANKS. That is correct.

Mr. PARRIS. That is what drives the problem; isn't it?

Mrs. FAIRBANKS. It certainly is one of the factors that drives the problem, no question. I would note again that if institutions are publicly advertising high rates, we know about that and are accountable for what we do about that. We don't know what institutions are doing on their telephones in securing brokered funds.

Mr. PARRIS. Last time I heard, Mrs. Fairbanks, I think it was about $6 billion in FSLIC, is that roughly the right number—I think in your testimony you indicated there was about four times that amount in brokered deposits in classified S&L's. Is that not correct?

Mrs. FAIRBANKS. Yes; although I don't know where the original figure came from. I was giving you our figures as of December 1984.

Mr. PARRIS. That was roughly $25 billion if I recall your testimony; is that correct?

Mrs. FAIRBANKS. $22.1 billion in problem institutions insured by the FSLIC.

Mr. PARRIS. My point, and hopefully this is too gross to consider in the real world—if all of those classified S&L's were to fail tomorrow it would represent 400 percent of the total insurance fund, is the point I am trying to make, is that correct?

Mrs. FAIRBANKS. I think that is exactly the point that was meant to be taken.

Mr. PARRIS. Thank you.

On page 12 of your statement, Mrs. Fairbanks, you go into, and you state that in your opinion the real question is much beyond the question of brokered funds totally: Hasn't the time come for the Congress to reaffirm that the real purpose of the insurance system is to protect the small, relatively unsophisticated saver and to assure that saver's confidence in the financial system; that the insurance of an account is an agency function—not a wide open playing field subject to twisting and bending by huge, sophisticated or clever financial giants.

What we are talking about the fundamental purpose of the existence of FSLIC, FDIC, and the rest. Is it to provide an opportunity for some lawful, hopefully sincere, totally legitimate money broker—have we provided a kind of a lucrative opportunity for him to enrich himself in a legitimate way? Is that really what we should continue to do with the provisions of insurance, or are we here—and are we about the guaranteeing of the solvency of an institution so that ma and pa will get back their deposit?

That is really what we are talking about, isn't it?

Mrs. FAIRBANKS. Yes; I would take that one step further. I would say that the notion that Federal deposit insurance is an individual entitlement is not consistent as I understand it with the development of the original legislation.

Federal deposit insurance is meant to be there for individuals in order to build confidence in a system, and there has to be a linkage between the individual and the system, as I understand it, to meet the original purpose for which Congress intended Federal deposit insurance to be used.

So, yes, I agree, Congressman, Federal deposit insurance is not an individual entitlement. I think it is meant to build confidence in a system.

Mr. **Parris**. Now, having said that, that is the good news. This is the bad news. You say on page 14 of your testimony that providing the FSLIC explicit statutory authority to determine what kinds of accounts are insured and what kinds are not insured would enable the Bank Board to bring clarity and sanity to this area. The problem I have with that is the same problem I have with H.R. 20, in terms of the definition.

In the ideal world it would be wonderful if you or Mr. Gray or both could sit in the steely night watch somewhere and define exactly what a legitimate S&L properly managed should be. It would be wonderful if you could determine which accounts should be insured in an ideal world. But can you really do that? You have already agreed with my general observation that maybe the examination process is not the answer.

So can we in our infinite wisdom, on this side of this table, write some language somewhere or you can create a regulation that will apply to an infinite number of business decisions that are made in the market every day? Can you really do that?

Mrs. **Fairbanks**. I would suggest at least that we believe we can do that and we believe you can do that and the scope of the problem that faces us is so large that I think it deserves that we try.

Mr. **Parris**. Well, I don't totally disagree with that, Mrs. Fairbanks. My time has expired. What I disagree with conceptually is that, and I am not sure that the principal that the "Government is here to help you" can solve all these problems.

By the same token I do share your concern that because of the unfortunate machinations of a few the industry and the security literally, certainly the confidence of the financial industry of this Nation, the delivery of financial services is growing in jeopardy, and I regret that very much. Now, what the answer is is a tougher question.

Mrs. **Fairbanks**. Could I respond to that, Mr. Chairman?

Mr. Congressman, I think that I joined the Reagan administration originally as an ardent advocate of free market principles, and I don't normally subcribe to the proposition that Government can help us in all things, but I certainly believe that we have taken on a mixed system in this country, and the Federal subsidy requires that we give adequate attention to the rules by which those institutions operate.

Mr. **Parris**. I agree with that. Thank you.

Thank you, Mr. Chairman.

Chairman **Hubbard** [presiding]. Thank you, Congressman Barnard, for chairing the subcommittee in my absence.

Congressman Rod Chandler of the State of Washington.

Mr. **Chandler**. Thank you, Mr. Chairman. I certainly agree with you on your point about the free market system, but as I undertand the financial deregulation, essentially you have got half of it on the free market basis, that being the price, but the risks, if you are within the $100,000 limit, is nonexistent and it seems to me that is what is the problem here.

If the depositor in that savings and loan wants to take advantage of high rates, then let them also take advantage of high risk. That is what I do when I buy a stock. I sit down with a broker and ask, Is this a sound investment and depending upon my desires, I can take a high risk and get a higher yield or I can take a lower yield but half a greater amount of security?

It seems to me that that is what has this equation knocked out of whack. On the one hand, you have deregulation on price but on the other hand, you have to accept higher than $100,000 deposits. The previous speakers said to limit the amount of brokerage deposits is going to be meaningless. That is your second choice as well.

Am I on the right track?

Mrs. **Fairbanks**. I think you are. However, after injecting any amount of market discipline into the operations of federally insured institutions, you are still left with the residual problem of the sale, if you will, of Federal deposit insurance and under what kind of controlled, regulated environment will that be done?

Mr. **Chandler**. Mr. Chairman, I have no further questions of the witnesses.

Chairman **Hubbard**. Thank you very much, Congressman Chandler, for being here and we welcome Congressman Henry Gonzalez of Texas. We had Mr. Joe Selby, Acting Comptroller of the Currency here earlier and he was concerned about your whereabouts.

Mr. **Gonzalez**. I can't understand that. I haven't had much dealings with him.

I ask unanimous consent that the record show that the reason I haven't been here is twofold: One, I had constituents and local officials; and second, I had a caucus meeting with some members of the Subcommittee on Housing with respect to what is happening on the budgetary level and that is the reason I couldn't be here.

I want to complement you for calling the sessions, Mr. Chairman.

Chairman **Hubbard**. Thank you very much. The reason Joe Selby commented about you, Congressman Gonzalez, is because he said he did at one time live in San Antonio, in your district.

I do have several questions, but I would like to submit them for the record and ask that you answer them at your first opportunity. I am thinking of the fact that I was not here to hear the other questions of our members.

Mrs. **Fairbanks**. I would be delighted to respond to your questions for the record.

[The questions submitted by Chairman Hubbard with Mrs. Fairbank's responses are contained in the attached letter that follows:]

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

SHANNON FAIRBANKS
Executive Staff Director
and Chief of Staff

November 7, 1985

Honorable Carroll Hubbard
Chairman, Subcommittee on
General Oversight and Investigations
Committee on Banking, Finance
and Urban Affairs
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

In response to your letter of July 26, 1985 concerning the July 16 hearing on brokered deposits, I have provided the following detailed answers to your questions. I apologize for the delay. After some checking I found that the letter had been misplaced by the staff assigned to gather the data included in the letter.

Question 1: What is the total of brokered deposits at FSLIC-insured institutions?

Answer: As of June 1985, the preliminary data indicate that there were $39.1 billion in brokered deposits.

Question 2: What share of the amount is insured?

Answer: Of those, $33.2 billion or 85 percent were insured.

Question 3: In January, 1984, Chairman Edwin J. Gray predicted that by the end of 1985, one-third of all deposits at FSLIC-insured institutions, or more than $260 billion, would be federally insured, money brokered funds. It now appears, per Merrill Lynch, that by the end of 1985 that number will be more in the neighborhood of $30 billion. Would you agree that the rate of placements of brokered deposits is stabilizing? If so, why the call for such drastic regulations to control a problem that seems to be working itself out?

Answer: As of December 1984, the total of brokered deposits at FSLIC-insured institutions was $43.0 billion. This figure had declined by almost 10 percent as of June 1985. The principal reason for this decline is due to a significant reduction in the use of brokered funds by certain large institutions in California. This reduction in the use of brokered funds is clearly tied to the Bank Board's revised net-worth and direct-investment regulations.

The direct investment rule limits the amount of such investments to a prudent relationship to the institution's capital. Formerly, states such as California and Texas permitted such investments up to 100% of assets. Now that these institutions must seek prior approval if such investments are to exceed 10% of assets, the profitability from the risky use of purchased liabilities has been significantly reduced. In other words, a California state-chartered thrift has much less economic incentive to offer high deposit rates to attract funds from a more regulated market, since now their ultimate re-use of these funds is not significantly different from an institution in the latter market.

The net worth requirement inhibits a large increase in liability growth without a corresponding increase in capital. Thus, many institutions have been forced to reduce their deposit growth until sufficient capital can be raised.

Although the amount of brokered funds is less than was predicted in 1984, we observe significant problems in institutions still relying on brokered funds. Specifically, we have seen brokered funds used in "linked" financing arrangements (e.g., requiring that deposits delivered by brokers be used for specific purposes which generally entail substantial risk.) For example, in one instance a deposit broker delivered high-rate deposits and then provided uses for the funds in the form of speculative loans to real estate development projects across the country. When the developers defaulted on the loans, the association was left with the greatly overvalued collateral and, therefore, huge losses.

Brokered funds pose a hazard to other healthy financial institutions. The healthy institutions must compete for funds with these other institutions that can afford to pay more for their funds since they are investing in higher risk, higher yield assets. This strategy known as an "end of game play" is a final attempt for institutions to grow out of their problems. The prudent institution may now find it increasingly difficult to raise funds at a profitable spread in relation to local mortgage rates.

More importantly, these brokers are explicitly taking advantage of FSLIC insurance. Since they are receiving federal deposit insurance for funds they place, they are marketing FSLIC insurance to sell their product. This is not the purpose of the insurance fund and curtailment of their activities would serve to direct the fund to its real purpose--to protect the deposits of small investors who trust their savings and loan institutions, via the Federal Government, to protect their personal savings.

Question 4: Do you agree with the House Government Operation's Subcommittee report that brokered deposits in problem institutions are actually declining?

Answer: We agree with the House Government Operation's report that states, "In the first three months of 1984, brokered deposits grew at an annualized rate of more than 100 percent in problem S&Ls, but during the next six months the brokered deposits of the same institutions declined at a 20 percent annualized rate. Problem institutions in the report were those with a supervisory rating of 4 or 5 as of March 31, 1984. However, we are unable to verify that this decline has been maintained for these institutions at the present time because of possible mergers or acquisitions.

Question 5: Do you feel that, if the federal insurance limit was reduced below $100,000, the public confidence in the banking industry would be undermined?

Answer: We are satisfied with the current $100,000 level for federal deposit insurance. The basic underlying purpose of deposit insurance is to provide stability in our financial system by maintaining public confidence in the safety of their deposits. Returning to the $40,000 insurance level or another level lower than the current $100,000 limit would not increase the stability of depository institutions.

The lowering or reduction of deposit insurance coverage instead could well lead many depositors to question the soundness of the federal deposit-insurance funds as well as the ability and willingness of the United States to place its credit at their disposal. Such doubts would severely erode depositor confidence leading many to divide their accounts among several institutions in an effort to obtain 100 percent deposit insurance coverage. The result of such depositor scrambling would be an increase in deposit runs and liquidity problems exacerbating the fragility of already weakened institutions and ultimately threatening systematic stability.

Those who advocate a reduction of insurance coverage argue that lower levels would increase the proportion of deposits at risk and subject to loss in the event of an institution's insolvency. Such an increase of risk, it is argued, would encourage, if not require, depositors to investigate an institution's financial health before placing any monies with the institution. We fully support the principle of increased depositor awareness. However, a reduction of deposit insurance would exact too high a price for thrifts and depositors alike by increasing deposit volatility fueled by rumor and speculation concerning the safety of depositor monies in any particular institution. The goal of stability provided by deposit insurance would not be furthered by a return to the days of widespread speculation and liquidity trauma.

I hope that we have fully responded to your questions and have helped clarify the Bank Board's position on such a vital issue as brokered deposits.

Sincerely,

Shannon Fairbanks

Shannon A. Fairbanks
Chief of Staff and
Executive Staff Director

Chairman HUBBARD. Do you have any questions of Ann Fairbanks, Chief of Staff of the Federal Home Loan Bank Board?

Mr. GONZALEZ. No, Mr. Chairman.

I wish to thank the witness for having answered your invitation. It would be unfair for me in the absence of knowing exactly the presentation, so I defer for the moment. I may have some to submit in writing, and I ask unanimous consent I may be allowed to do so.

Chairman HUBBARD. Without objection, that is allowed and ordered.

Ann Fairbanks, thank you so much. I apologize for being absent during your testimony.

We now call on panel 2. We have three witnesses on the second panel. We will have the 5-minute rule in operation.

We will hear from Emanuel J. Falzon, president, Merrill Lynch Money Markets, Inc., of New York; Ray Thomas, first vice president and assistant general counsel, Dean Witter Reynolds of New York; and Dick Reibman, managing director of Dean Witter Reynolds.

We look forward to your comments and testimony.

Let's proceed with our first witness as far as we can go.

Emanuel Falzon.

STATEMENT OF EMANUEL J. FALZON, PRESIDENT, MERRILL LYNCH MONEY MARKETS, INC.

Mr. FALZON. Thank you, Mr. Chairman and good morning.

My name is Manny Falzon and I am the president of Merrill Lynch Money Markets, Inc., which is the Nation's largest dealer in commercial paper, bankers' acceptances, and certificates of deposit.

I want to thank you, Mr. Chairman and members of the subcommittee, for holding this hearing on brokered deposits at what is certainly a very busy time for the Congress. I have submitted a full copy of my testimony which I request be made part of the hearing record.

In the short time available to me today, I would like to cover:

One, the brokered deposit market and Merrill Lynch's role;

Two, our perspective on some of the FDIC and Bank Board concerns with brokered deposits; and

Three, why H.R. 107 is an appropriate legislative response to the brokered deposit controversy.

Let me begin by explaining that the brokered deposit market is not a single homogeneous market. There are, in fact, three distinct markets.

The oldest and largest is the institutional/uninsured market which is not directly related to the deposit brokerage controversy.

The remaining two markets consist of insured deposits, but they are quite different. In one of these markets, the far larger of the two, Merrill Lynch and other multiservice, regulated brokerage firms place deposits for individuals in average amounts of $14,000 and average maturities of 3 years, with banks and thrifts which have been screened by professional credit analysts.

In the last and smallest market institutional investors use money brokers to spread large deposits over a number of banks and thrifts in $100,000 pieces to achieve full insurance and high yields. This market has grown significantly since the 1982 Penn Square failure in which institutional investors were not able to recover their uninsured deposits. The abuses usually referred to by the FDIC and the Bank Board have occurred in this market.

Merrill Lynch is proud of its involvement in the first two markets, the institutional/uninsured market and what we call the retail CD market. These two markets account for the vast bulk of brokered deposits and provide enormous benefits to depository institutions, individuals and the economy as a whole. Neither market contains the kinds of problems attributed by the agencies to the abusive use of brokered deposits.

By abusive use of brokered deposits, I mean, of course, the objectionable practices to which the insurance regulators frequently refer, such as banks on the verge of failure loading up on high-priced short-term deposits; weak thrifts using brokered deposits to fund rapid growth; deposit spreading on behalf of institutional investors such as banks, thrifts and credit unions; and brokers providing deposits directly linked to a questionable loan in which they have an interest.

Merrill Lynch does not engage in such practices, nor do we believe that such practices are a problem in the market served by the major brokerage firms. Rather, they are almost exclusively found in the smallest market segment, the institutional/insured segment.

We object to the efforts of the insurance agencies to discredit all brokers and eliminate insured deposit brokerage because of the abuses attributable to this small, discrete segment of the market.

The agencies claim that deposit brokerage is a severe threat to the insurance funds. In addition to ignoring the existence of the three distinct markets, this claim is premised on unfounded projections of brokered deposit growth, faulty analysis of recent failures, misleading and inaccurate estimates of brokered deposit use by weak institutions, and disregard for the credit screening performed by the leading brokerage firms.

For example, early in 1984, the Bank Board projected that by the end of 1985, one-third of all deposits at FSLIC-insured institutions, or more than $260 billion, would be insured brokered deposits. It is now clear that such deposits will be less than $30 billion at year end.

Numerous studies over the past year, including two by the House Government Operations Committee, have challenged the agencies' claims. The Barnard subcommittee found, for example, that brokered deposit use has actually declined among failed and problem institutions.

Similarly, Cates Consulting Analysts, Inc. has just completed a comprehensive study of banks and thrifts which failed in the last 3½ years, which shows that while the number of failures has increased, brokered deposit use has declined and is not even a factor in the vast majority of these failures.

Mr. Chairman, I would like to set the record straight with respect to statements made regarding Merrill Lynch's involvement with failed institutions: There has been over 360 bank——

Chairman HUBBARD. I am anxious to hear those comments but forgive me, I am going to have to vote. I have learned in the past it is best to vote when you are on the Hill regardless of what the issue is.

Please excuse me as we have to call the subcommittee in recess for 10 minutes while I go over to vote.

The subcommittee now is in recess.

[Brief recess.]

Chairman HUBBARD. The subcommittee is again called to order, and we would ask Manny Falzon to back up a paragraph and make a rerun at it. You were just about to hit a high spot there, so back up a paragraph or two and give it to us again.

Mr. FALZON. Thank you, Mr. Chairman.

Similarly, Cates Consulting Analysts, Inc. has just completed a comprehensive study of banks and thrifts which failed in the last 3½ years, which shows that while the number of failures has increased, brokered deposit use has declined and is not even a factor in the vast majority of these failures.

Mr. Chairman, I would like to set the record straight with respect to statements made regarding Merrill Lynch's involvement with failed institutions: There have been over 360 bank and thrift failures since 1982 when Merrill Lynch began insured deposit brokerage, but there has not been one instance of a bank or thrift failure involving Merrill Lynch and the abusive use of brokered deposits.

Recent references to a failed bank in Puerto Rico as a bank for which Merrill Lynch brokered CD's are completely inaccurate. The CD's in question were bought by a Merrill Lynch subsidiary for its own account and were neither brokered nor fully insured.

In fact, there has been only one instance in which an assisted merger involved an institution for which Merrill Lynch had brokered deposits. The FDIC has unfairly and erroneously referred to our involvement in this Texas bank as an example of abuse when, in fact, Merrill Lynch was very diligent in analyzing the financial condition of this bank, had placed the deposits at a time when the bank was generally considered creditworthy and had discontinued placing CD's when it became clear that the bank's position had deteriorated.

For each of its issuers, Merrill Lynch conducts credit reviews of regulatory and audited financial reports covering several years, and has discussions and visits with management to evaluate funding and lending policies and management capabilities. Although, obviously, Merrill Lynch cannot and does not guarantee in any way the creditworthiness of any issuer, we do assess an institution's viability before placing a customer's deposits with any bank or thrift. Our evaluation process results in the rejection of more than half of the banks and thrifts interested in issuing CD's through Merrill Lynch.

In view of our procedures and our excellent record to date, the repeated attempts to discredit our evaluation process and link Merrill Lynch with weak and risky depository institutions are irresponsible and unfounded.

We are here today because many in Congress, including several members of this subcommittee, would like to see the brokered deposit issue resolved by legislation, but are legitimately concerned about how to put an end to the abuses while preserving the many benefits in the market. The House Banking Committee has before it a bill, H.R. 107, which we believe successfully resolves these concerns.

As Congressman Garcia, a sponsor of the bill, has said: "H.R. 107 strikes a reasonable balance. It recognizes the benefits that brokered funds can provide and the abuses currently existing in the system."

I would like to review the major provisions of H.R. 107 because I agree with Congressman Garica that this bill "strikes a reasonable balance."

The most important provisions of the bill involve limitations on short-term brokered deposits. To the extent that brokered deposits have been associated with bank and thrift failures, they have been deposits with maturities of less than 1 year made on behalf of institutional investors. Every horror story to which the agencies have alluded concerning brokered deposits has involved such short-term brokered deposits.

If H.R. 107 is enacted, access to short-term brokered deposits would be tied to an institution's unimpaired capital and surplus. The bill would prohibit undercapitalized depository institutions from having any insured short-term brokered deposits and would allow even the healthiest banks and thrifts to have only a small amount. It would prevent any institution from becoming too dependent on short-term insured brokered deposits and would also address the agencies' concern that an institution which is in sound condition can, in a very short period of time, become financially troubled. A limitation on the amount of short-term insured deposits a depository institution may acquire through brokers would prevent an institution from rapidly expanding in a manner inconsistent with the institution's safety and soundness.

H.R. 107 would not restrict the medium- and long-term brokered CD market because such deposits have not been associated with the abuses cited by the agencies. Furthermore, longer-term brokered deposits provide the following significant benefits which would be lost if they were needlessly restricted:

One, a primary use for such funds is to finance housing.

Two, longer term deposits also help depository institutions strengthen their balance sheets by taking on liabilities which match their longer term assets. Such efforts have been applauded by the regulators.

Three, the primary depositors are individual savers. For example, close to 90 percent of the Merrill Lynch customers who buy medium- and long-term CD's are individuals.

Four, such deposits are often the cornerstone of long-term savings for children's education or retirement.

Five, the secondary market maintained by brokerage firms provides individual depositors with enhanced liquidity and allows depository institutions to avoid early redemptions.

It has been suggested that medium-term deposits are no different from short-term deposits and that limiting only the short will encourage deposits of a year and 1 day. H.R. 107 would prevent this occurrence by some well-crafted checks and balances. In fact, the combination of provisions in H.R. 107 will ensure that the abuses in the market are eliminated and do not simply move into another segment.

For example, brokers in the institutional/insured market are dependent on the presence of a large number of institutional depositors and a large number of banks and thrifts as deposit takers. This bill limits both the depositors—by denying insurance to several classes of institutional depositors such as credit unions, banks and thrifts—and the deposit takers—by prohibiting weak depository institutions from acquiring short-term brokered deposits and by limiting the amounts that even healthy institutions may accept.

Mr. Chairman, H.R. 107 would deal effectively with the specific problems affecting deposit brokerage and eliminate any threat to the insurance funds from certain deposit brokerage activities. But this bill would preserve the rights of individual savers and the benefits of brokered deposits to well-managed banks and thrifts and to the economy as a whole.

In closing, I would like to say that Merrill Lynch shares the agencies' concerns about the safety and soundness of financial institutions and the integrity of the insurance funds. We are also deeply concerned about abuse use of brokered deposits by weak institutions. However, as we have just discussed, brokered deposit use is down while failures are up. We believe it is time to resolve the brokered deposit controversy and focus on the important tasks of preventing failures, increasing the soundness of depository institutions and strengthening the insurance fund.

Let me thank you and the other members of the subcommittee for allowing me to present Merrill Lynch's views and to briefly explain the importance of deposit brokerage.

Mr. Chairman, I will be happy to answer any questions you or your colleagues may have.

Chairman HUBBARD. Thank you very much, Manny Falzon.

[The prepared statement of Mr. Falzon and miscellaneous material follow:]

STATEMENT OF
EMANUEL J. FALZON, PRESIDENT
MERRILL LYNCH MONEY MARKETS INC.
BEFORE THE SUBCOMMITTEE
ON GENERAL OVERSIGHT
AND INVESTIGATIONS
OF THE
COMMITTEE ON BANKING,
FINANCE AND URBAN AFFAIRS
OF THE
UNITED STATES HOUSE
OF REPRESENTATIVES

July 16, 1985

I. Introduction

Mr. Chairman and distinguished members of the Subcommittee, I am Emanuel Falson, President of Merrill Lynch Money Markets Inc., which is the nation's largest dealer in money market instruments such as commercial paper, bankers' acceptances and certificates of deposit. We place, on average, more than $1 billion per day in such instruments. I would like to thank you for giving me the opportunity to appear before you in connection with your deliberations over the important and complex issue of brokered deposits.

Before proceeding, let me make clear Merrill Lynch's position on brokered deposits. Merrill Lynch is proud of its positive contributions to the development of the certificate of deposit market. In particular, Merrill Lynch takes pride in the leading role it has assumed in making certificates of deposit available to individual depositors and in providing greater access to medium-term funds to responsible small and medium-sized depository institutions. These developments have been unqualified successes. The brokering of medium-term insured deposits for individuals provides market access alternatives that might otherwise not be readily available. This occurs without putting the insurance funds at risk. In addition, deposit brokerage enables local and regional financial institutions to obtain access to funds that would, without such intermediary activities, be the sole preserve of larger competitors with national presence. Moreover, deposit brokerage facilitates the efficient flow of capital to areas of need and into nationally favored assets, like housing.

At the outset, we agree that there are certain abuses in the deposit brokerage market -- specifically, in one segment of the market -- and that such abuses need to be addressed by legislation. Merrill Lynch fully supports those measures, such as H.R. 107, a bill now before the House Banking Committee, that would deal with the problems that do exist and are legitimate concerns of the agencies. We oppose, however, unnecessary re-regulation and other actions that would eliminate depositor options, reduce competition among banks and thrifts and harm the economy.

Before giving you Merrill Lynch's recommendations concerning the various alternatives that may be considered in addressing the brokered deposits issue, I would like to review briefly (i) recent regulatory, legislative and judicial developments relating to deposit brokerage, (ii) the character of the brokered deposit market and its benefits, and (iii) two issues pertaining to the insurability of brokered deposits, namely, the risks, if any, posed to the deposit insurance funds by deposit brokerage and the consistency of deposit brokerage with the legislative intent underlying the deposit insurance acts. In so doing, I hope to make clear that the role Merrill Lynch and the vast majority of other deposit brokers have played is a positive one -- and very different from the picture the federal deposit insurance agencies have painted.

II. Background

On March 26, 1984, the Federal Deposit Insurance Corporation (the "FDIC") and the Federal Home Loan Bank Board (the "Board"), as operating head of the Federal Savings and Loan Insurance Corporation (the "FSLIC"), issued a rule (the "Invalidated Rule") which, had it taken effect, would have aggregated, and insured only up to $100,000 in the aggregate, all deposits placed by or through a deposit broker at a single insured depository institution, without regard to the number of beneficial owners of such deposits. Because the beneficial owner of a brokered deposit would effectively have been denied deposit insurance, the Invalidated Rule would have had the effect of virtually eliminating the brokerage of insured deposits.

On June 20, 1984, the United States District Court for the District of Columbia overturned the Invalidated Rule on the ground that the agencies lacked the statutory authority to promulgate the Invalidated Rule. On January 30, 1985, the United States Court of Appeals for the District of Columbia Circuit affirmed the District Court's decision.

As will be made clear by my testimony, the Invalidated Rule would have had, and any future measures aimed at eliminating or significantly curtailing insured deposit brokerage will have, the effect of (i) denying individual savers the broadest possible choice of safe, liquid and competitively priced savings options, (ii) denying access to national markets and medium-term funds to sound depository institutions, particularly medium- and small-sized institutions, and (iii) eliminating the benefits which deposit brokerage has provided to the national economy. In general, the Invalidated Rule and similar measures represent an attempt to eliminate imperfections in the bank and thrift industry caused by deregulation through sweeping and unnecessary regulatory or legislative intervention.

The primary reason the FDIC and the Board have offered in support of the Invalidated Rule and other measures to limit deposit brokerage is that deposit brokerage is, in their perception, a severe threat to the integrity of the federal deposit insurance funds. While the FDIC and the Board are properly concerned with the integrity of the insurance funds, deposit brokerage in and of itself does not pose a threat to the viability of the insurance funds. In fact, numerous governmental studies concerning the viability of the insurance funds have concluded that poor management of assets, vulnerability to high interest rates and imperfections in the supervisory process -- not deposit brokerage -- threaten the insurance funds. The credit screens used by the major brokerage firms actually preserve the integrity of the insurance funds by strengthening depository institutions and increasing the premium base of the insurance funds.

The FDIC and the Board have also stated that deposit brokerage is a "misuse of the federal deposit insurance system" and that deposit insurance was "never intended to protect investors seeking the highest yields available in money markets". We believe deposit brokerage is fully consistent with the purposes Congress sought to achieve by creating the FDIC and the FSLIC and that, as the decisions of the United States District Court for the District of Columbia and the United States Court of Appeals recognize, all depositors were intended to be protected by deposit insurance up to the maximum amount irrespective of yield or method of deposit placement.

The primary benefit brokerage firms provide is inherent in their roles as financial intermediaries. As with other financial intermediaries, brokerage firms bring together persons wishing to deposit or invest money with those institutions seeking funds. By bringing together depository institutions and depositors and by maintaining a secondary market, brokerage firms have helped create a more efficient, nationwide market for deposit instruments. This market helps ensure that capital will flow from where it is available to where it is needed, thereby helping to maintain a viable national economy.

As you know, since the June 20, 1984 decision, a number of bills dealing with brokered deposits have been introduced in both Houses of Congress. We believe that H.R. 107, introduced by Representatives Garcia, Schumer and Barnard, represents a constructive attempt to maintain the benefits provided by deposit brokerage while empowering the agencies to deal with those situations in which the misuse of deposit brokerage by unsound institutions can compromise the integrity of the deposit insurance funds.

Both the FDIC and the Board have proposed legislation (H.R. 1680, S.759, H.R. 1833, S.760) which, while not directly limiting brokered deposits, would in effect give each agency broad new powers to promulgate rules, like the Invalidated Rule, to limit or eliminate deposit brokerage.

Merrill Lynch supports legislative solutions to the brokered deposits issue which will both address the concerns associated with misuses of deposit brokerage and at the same time preserve the overall benefits of deposit brokerage to individual savers, depository institutions and the national economy. We also believe that certain of the solutions proposed -- such as limiting the percentage of short-term brokered deposits -- are far preferable to both the Invalidated Rule and the sweeping grant of power to the regulatory agencies that is contemplated in the legislation proposed by the FDIC and the Board.

III. The Brokered Certificate of Deposit Market

A. Market Structure

We believe that an understanding of the brokered deposit market is necessary in order to establish legislative or regulatory changes which will solve the problems which can fairly be ascribed only to a certain small segment of the brokered deposit market while maintaining the beneficial functions of the rest of the market. We believe that a dispassionate analysis of the brokered deposit market indicates that the brokered deposit "market" actually consists of three markets. Most importantly, we believe the different characteristics of each of the three markets establish a need for legislative or regulatory responses that take into account such differences. The three distinct markets for brokered certificates of deposit ("CDs") are as follows.*

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* In Exhibit I, the markets described below are summarized.

Institutional Uninsured Certificates of Deposit. In this market, which has existed since the early 1960's, institutional investors such as money market funds, corporations, bank trust departments and insurance companies purchase CDs of the larger banks and a handful of the largest thrifts. The money center banks and large securities firms such as Salomon Brothers, Shearson Lehman American Express, First Boston, Dean Witter, Prudential-Bache and Merrill Lynch participate in a secondary market which provides liquidity for investors. Approximately $100 billion in CDs in denominations of $100,000 and above are outstanding at any one time in this market, and approximately 40%-50% of the CDs in this market are placed through national brokerage firms. The average maturity is less than ninety days and the average transaction size is $5 million. Given this average transaction size, $100,000 of deposit insurance is not a key factor for purchasers of these CDs* and investment decisions by participants in this market generally subject bank and thrifts to the "market discipline" which the FDIC and the Board have advocated.

It appears from the Invalidated Rule that the FDIC and the Board have not been concerned about this institu-

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* Certain parties for whose benefit such CDs are purchased, such as beneficiaries of pension funds and bank trust department clients, are entitled to the flow through of insurance benefits, however.

tional uninsured certificate of deposit market. Nevertheless, the agencies have incorrectly included this segment of the brokered deposit market in issuing warnings about the size and growth of the brokered deposit market and the perceived resultant exposure to the insurance funds. Because these deposits do not expose the insurance funds to any significant degree of risk, it is at best disingenuous and at worst misleading for the agencies not to differentiate this uninsured market from the insured brokered deposit market in speaking of increased risks to the insurance funds.

For example, Penn Square Bank, N.A. was a participant in this uninsured certificate of deposit market. When it failed, the institutional uninsured depositors were the losers -- according to the FDIC's analysis of the Penn Square failure, over half of Penn Square's $465 million in deposits were uninsured. We understand that there were no insured brokered funds of individual savers in Penn Square. Even if brokered deposits had contributed to the failure of Penn Square, the Invalidated Rule would have done nothing to prevent its failure, since the bulk of the brokered deposits in Penn Square were uninsured.

Institutional Insured Certificates of Deposit. In 1980 the maximum FDIC/FSLIC insurance limit was raised to $100,000. Earlier, interest rate ceilings had been removed on deposits of $100,000 or more. These factors combined to cause the development of a market serviced for the most part by unregulated brokers who assist institutional investors in breaking up their funds into $100,000 fully insured pieces. Growth in this market accelerated after the Penn Square failure in 1982 as more institutional investors began to substitute full insurance protection for their own credit analysis.

The market in brokered institutional insured deposits is characterized by unregulated brokers dealing almost exclusively with institutional investors. The overwhelming majority of deposits in this market have short-term maturities and, to our knowledge, neither the brokers nor the institutional investors participating in this market generally undertake credit analyses of the depository institutions involved. This is the market, therefore, that a troubled, cash-starved institution would look to for a quick infusion of funds, relying on federal deposit insurance and attractive interest rates, rather than its own creditworthiness.

The institutional uninsured market is the market in which the problems attributed by the agencies to brokered deposits have occurred. These abuses include: the loading up on high-priced short-term deposits by banks on the verge of failure; the use of brokered deposits by weak thrifts to fund rapid growth; deposit spreading on behalf of institutional investors, such as banks, thrifts and credit unions; and brokers' providing deposits linked to a financing in which they have an interest.

We estimate the size of this market to be nearly $10 billion in CDs of banks and thrifts. While we believe that most of the funds in this market are going to sound depository institutions, we believe, based on conversations with the staffs of the FDIC and the Board as well as our knowledge of deposit brokerage, that the overwhelming majority of the brokered deposits of recently failed banks and thrifts are part of this market -- short-term funds placed by unregulated money brokers on behalf of institutional investors.

Individual Insured Deposits. The individual insured deposit market developed approximately three years ago when the Depository Institutions Deregulation Committee ("DIDC") began to deregulate interest rates on time deposits of less than $100,000. The DIDC also authorized these "deregulated CDs" to be issued in negotiable form. This negotiability feature permitted an active secondary market to develop in the individual deposit market and, combined with deregulated rates, provided individuals with the same benefits (liquidity and competitive market rates) that participants in the institutional deposit market had enjoyed for two decades. Negotiability obviously implied the participation of intermediaries such as bona fide brokers in this market, since depository institutions are effectively prohibited from making markets in their own time deposits.*

This market is serviced by the leading national brokerage firms (all of which are heavily regulated) and is dominated by deposits in relatively small denominations (individual savers' transactions average approximately $14,000) and maturities of over one year. For example, of the over $13 billion that Merrill Lynch's customers currently have on deposit in approximately 100 banks and thrifts, 93% was placed in CDs with maturities of at least one year and the average maturity is over three years. A substantial amount of the deposits are placed with individuals pursuant to Individual Retirement Accounts ("IRAs") and Keogh plans.

Many of the large national brokerage firms have historically maintained secondary markets for their investors in CDs in this market. Consequently, the firms will often hold for their own accounts amounts well in excess of $100,000 of a single institution's CDs. The brokerage firms thus may be at risk with the banks and thrifts they represent since the

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* See 12 C.F.R. §217.159.

CDs the firms hold are not fully insured. For example, as a result of secondary market activity Merrill Lynch frequently holds over $100 million of these CDs, including, in the case of one or more institutions, several million dollars worth of CDs. Merrill Lynch and, we believe, other firms, therefore of necessity conduct credit analyses of prospective issuers (In Exhibit II, Merrill Lynch's credit procedures for the insured individual market are summarized). We conduct credit reviews of prospective issuers also to avoid jeopardizing our reputation of providing sound investments for our customers and to avoid subjecting our customers to the potential uncertainties and delays associated with FDIC and FSLIC payouts.

The relationship in this market between a bank or thrift and the national brokerage firm it selects is similar to that in other investment banking situations. Once the rate, commission, amount of issue and maturity of the CDs to be placed are established and a credit analysis of the depository institution has been completed, the brokerage firm begins marketing the bank or thrift offering through its distribution system. In this market, the brokerage firms compete for bank and thrift clients.

In Exhibit III, we have provided a chart which describes the composition of the depositor population which Merrill Lynch serves in this market. The FDIC wrongly implied in a recent press release that the bulk of the deposits placed by Merrill Lynch were from banks, thrifts and credit unions. As the chart indicates, 88 percent -- almost 9 out of 10 -- of the insured certificate of deposit transactions Merrill Lynch executes in this third market are made for individual investors. Given the magnitude of this proportion, Merrill Lynch continues to be confounded by the allegations and innuendos that have been made by the FDIC and the Board about Merrill's role as a deposit broker. For it is the protection of these individual depositors served by Merrill Lynch which has always been one of the primary goals of the deposit insurance system.

Summary. The critical conclusion to be derived from an analysis of the brokered certificate of deposit "market" is that the "market" is simply not a single homogeneous market. We believe that the real brokered deposit problem is confined to the second of the three markets described above -- the institutional insured market -- and does not relate to either the institutional uninsured or individual insured markets. These two markets account, by our estimates, for the vast bulk of brokered certificates of deposit sold. However, neither market contains the problems attributed by the FDIC and the Board to brokered deposits generally. We object strongly to the efforts of the FDIC and the Board to discredit all brokers and eliminate all deposit brokerage because of abuses attributable to a small, discrete segment of the overall market.

B. Benefits of Deposit Brokerage

The benefits deposit brokerage has provided to individual savers, depository institutions and the economy as a whole are considerable. Indeed, a simple "cost-benefit" analysis comparing the significant benefits to the minimal "costs" that could be associated with deposit brokerage* leads inescapably to the conclusion that deposit brokerage should not be eliminated. The benefits deposit brokerage provides include the following.

Individual Savers. The individual saver has received little mention in the discussion of insured deposit brokerage. Given current regulatory trends toward granting individuals freer access to financial markets, this is rather remarkable and represents a step backward. We have championed the cause of the individual, and we believe that the interests of this group need to be protected during the debate on deposit brokerage. This is the same group, after all, which for decades was denied the market rates available to institutional investors.

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* See Exhibit IV for two American Banker articles published in 1984 and 1985, respectively, in which the benefits and costs of deposit brokerage are discussed. The articles conclude that any problems associated with deposit brokerage can be addressed with minor reforms, and reject the agencies' solution in the form of the Invalidated Rule.

An important result of the availability to individual savers of brokered deposits is that the individual saver is able to participate in what has now become a national market for deposit instruments. The specific benefits individual depositors may receive are (1) more competitive rates (when local rates are not competitive), (2) wider choices of maturities (up to 14 years) at a fixed rate, and (3) enhanced liquidity. If federal insurance of brokered deposits is eliminated, the many benefits which deposit brokerage has provided the individual saver would be sacrificed.

As indicated by the number of individuals participating in this market, the individual saver has found access to the broader markets provided by deposit brokerage to be highly desirable. To date, more than one million people have purchased CDs through brokerage firms, frequently for inclusion in trust, IRA, Keogh and other custodial accounts. The removal of federal insurance of brokered deposits would virtually eliminate the brokered deposit as a choice for these people.

In summary, deposit brokerage has brought to individual savers the benefits which Congress envisioned they would enjoy when it created the DIDC in 1980 and instructed it to deregulate interest rates on deposits. Congress hoped that individuals would enjoy market rates of return, have many different deposit instruments to choose from and benefit from the liquidity of a secondary market. Through the brokerage of insured CDs, the goals of deregulation have been furthered. To eliminate brokerage of insured deposits to individuals would represent a step backward for these objectives.

Depository Institutions. Deposit brokerage activities have also resulted in substantial benefits to depository institutions. The benefits have been particularly important in the recent deregulatory environment in which small and medium-sized depository institutions have been compelled to compete for funds with the large money center banks and other financial institutions.

As a result of deposit brokerage activities, many creditworthy depository institutions are now better able than they were in the past to avail themselves of a national capital market in their effort to raise funds, both from institutional investors and from individuals. In this regard, curtailment of the brokered deposit market favors the largest financial institutions with massive intra- and interstate branch systems and the commensurate advertising and sales capability to reach a regional and national customer base. The elimination of federal insurance of brokered deposits would have the effect of destroying the national market in insured certificates of deposit and would deprive many small and medium-sized depository institutions of this cost-effective source of new funds, particularly for longer maturities.

In addition, deposit brokerage has significantly reduced the problem of disintermediation of funds from many depository institutions. A significant portion of the funds raised by depository institutions through brokerage firms has come directly from money market funds and other investment vehicles available through brokerage firms, providing net new funds to banks and thrifts. This new source of funding to banks and thrifts has contributed to lower interest rates as well. If deposit brokerage were curtailed, individuals who have purchased deposit instruments made available by brokerage firms would resume placing their funds in alternative investments through the brokerage firms, thus resulting in a loss of funds to depository institutions.

Deposit brokerage programs have also provided one of the few cost-effective means for small and medium-sized banks and thrift institutions to raise medium-term deposits. The raising of medium-term deposits enables many depository institutions, especially thrift institutions, to fund their medium to long-term assets, such as housing loans. This practice of "matched funding" fosters strength and stability in depository institutions.

In addition, many knowledgeable observers of the thrift industry have concluded that the single greatest threat to thrift institutions is the vulnerability of thrifts to higher interest rates. To reduce interest rate vulnerability, thrifts need to "restructure" their balance sheets by taking more long-term deposits. Last year, a study of the thrift industry indicated that over $300 billion of short-term thrift liabilities were being used to fund long-term assets. Placing restrictions on deposit brokerage without distinguishing between short-term and longer-term deposits would limit access to one of the best balance sheet restructuring tools currently available to thrifts -- just when they need it most.

Fears have been expressed by the FDIC and the Board that, due to deposit brokerage, depository institutions will become "hostage to" deposit brokers. Given the competitive nature of the various funding markets for healthy depository institutions, the fear that depository institutions would become overly reliant upon brokered deposits is far-fetched. Healthy institutions have access to many sources of funds, and a well managed depository institution will never become overly reliant on (or a "hostage to") any single funding alternative. For years, money center banks and large thrifts have been using brokered deposits without provoking this concern (up to 40% of the deposits of some money center banks are raised by intermediaries). To raise the "hostage" issue as a concern for the individual negotiable CD market both ignores market realities and slights the judgment and credibility of bank and thrift management.

A fear has also been expressed that brokerage firms will control the pricing of deposit instruments. This is ridiculous. Interest rates on deposit instruments placed by brokerage firms are set by the marketplace, exactly as in the case of other financial instruments. If interest rates are too high, banks and thrifts will not issue deposits; conversely, if rates are too low, savers will not deposit funds.

The average rates on deposit instruments offered through Merrill Lynch are comparable to national rates. (See Exhibit V for a comparison of recent one-year CD rates.) As would be expected in any free market, rates on CDs offered through national brokerage firms are generally lower than rates offered by depository institutions directly in capital deficit areas, and generally higher than local depository institutions offer directly in capital surplus areas. The interest rates on brokered deposits offered to individuals closely track the interest rates of United States government and agency obligations of comparable maturities.

The Economy. Deposit brokerage provides depository institutions with an additional, stable source of funds which may be used to increase the amount of funds available for housing loans. The removal of insurance of brokered deposits would thus eliminate an important source of funds for housing loans. This may have the effect of causing interest rates on housing loans to rise as these funds become more scarce.

In addition, as the Federal Reserve Board and other industry observers have noted, deposit brokerage has performed the important function of moving funds from areas of excess savings to areas in need of funding for the legitimate banking and credit needs of consumers and businesses. Thus, shutting down the market in insured brokered CDs would impair the efficiency of the nation's credit and savings markets by artificially restricting the flow of capital from where it is available to where it is needed. An additional effect of the elimination of deposit insurance of brokered deposits would be to increase the concentration of deposits in the largest banks, which currently are able to raise deposits nationally.

The Board has indicated that existing funding mechanisms, in particular Federal Home Loan Bank borrowings, will be able to meet the medium- and long-term funding needs of thrifts if insured deposit brokerage is eliminated. However, reducing the number and kinds of funding alternatives is economically inefficient. Federal Home Loan Bank borrowings are not, in general, a low-cost funding option* and our experience suggests that such funds are, at certain times and for certain maturities, more costly. At times brokered deposits are the most cost-effective choice.

If federal insurance of brokered deposits is eliminated, or if the brokered deposit market is significantly curtailed, competition among depository institutions would diminish. Small and medium-sized institutions will not be able to compete effectively with large institutions in their effort to attract funds. This, in turn, will make it more difficult for small and medium-sized institutions to compete for lending opportunities with large institutions since the smaller institutions will lack the funding required for these loans. This could result in a further concentration of assets in these larger institutions. In addition, diminished competition in the deposit market will undoubtedly lead to less competitive rates on deposits being offered by the remaining participants in that market.**

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* "Since the rate S&Ls have to pay on FHLB loans is set sufficiently high to cover the FHLB's borrowing cost, such loans are not a cheap source of funds to S&Ls." The Money Market, Revised Edition 1983, Marcia Stigum, Dow Jones-Irwin, p. 216.

** In a comment letter submitted to the agencies by the Department of Justice, the Department concluded that enactment of the then-proposed Invalidated Rule would have "seriously damage[d] competition and [been] wholly unwarranted".

IV. Insurability of Brokered Deposits

Any resolution of the brokered deposits question must address both the risks posed to the federal deposit insurance funds by the practice and the consistency of any proposed resolutions with the purposes of having a federal deposit insurance system. Merrill Lynch believes that the actions and statements of the FDIC and the Board evidence an inflated estimate of the risks posed to the funds by deposit brokerage. In addition, Merrill Lynch believes that, because deposit brokerage is fully consistent with the deposit insurance statutes, curtailment of deposit brokerage will not further the interests intended to be served by the deposit insurance system.

A. Minimal Risks Posed by Deposit Brokerage

The continuing efforts of the FDIC and the Board to eliminate federal insurance of brokered deposits and to otherwise restrict the deposit brokerage business evidence a failure to recognize the differences among the three brokered deposit markets -- particularly the profound differences between the two insured markets -- and the enormous benefits provided by deposit brokerage.

As a result of not understanding the brokered deposit market, the agencies have reached erroneous conclusions about deposit brokerage. The Board's projection of the growth rate for brokered deposits is, as discussed below, contradicted by market reality. Also, in speaking of the risks to the insurance funds posed by deposit brokerage, the agencies have failed to recognize that only insured deposits, which are the smaller part of the brokered deposit market, are relevant to the integrity of the deposit insurance funds.

The agencies have also failed to recognize that brokered deposits of individual savers are not a cause of financial instability at depository institutions. To the agencies, all brokered deposits are the same, whereas the brokered deposit market teaches us they are not. We fail to see how it makes sense to effectively eliminate the brokerage of insured deposits to individuals since this practice has not been associated with any of the problems the FDIC and the Board have attributed to deposit brokerage. On the contrary, the brokerage of insured deposits to individual savers actually strengthens depository institutions.

Recently, the Board proposed to revise its record-keeping requirements with respect to accounts at FSLIC-insured institutions.* While some of the changes proposed by the Board would serve to clarify existing regulations, portions of the proposed regulations, for which the Board has provided no cogent justification, are unnecessary and would be inconsistent with certain of the Board's stated goals and with sound policy.* In addition, such provisions would curtail or eliminate a number of effective and economical current arrangements through which significant amounts of negotiable deposits in FSLIC-insured institutions, including a substantial amount of brokered funds, currently are held. This would cause particular harm to the market involving small, individual depositors.

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* 50 Fed. Reg. 19185 (May 7, 1985).

It should be noted that FDIC Chairman William Isaac indicated during his appearance before the Subcommittee on Financial Institutions and Consumer Affairs of the Senate Committee on Banking, Housing and Urban Affairs (the "Senate Banking Subcommittee") last month that the FDIC intends to follow the Board's lead in similarly revising its own recordkeeping rules.

We have asked ourselves why the agencies chose to propose the Invalidated Rule, which was clearly too broad for the purposes it was intended to serve, and why the agencies have continued to oppose reasonable efforts to address the brokered deposits issue. The only conclusion that we have been able to reach is that the FDIC and the Board are seeking to exclude bona fide brokers from deposit brokerage at any cost, regardless of the expense to depositors, the safety of the very institutions the agencies seek to protect, and the economy.

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* A number of comment letters opposing the proposed regulations have been submitted to the Board, including a letter from the United States Small Business Administration which stated that the proposed regulations would have a "drastic effect on small banks".

Invalidity of Agencies' Predictions. In a speech delivered in January 1984, Board Chairman Edwin Gray suggested that, by the end of 1985, one-third of all deposits at FSLIC-insured institutions, or more than $260 billion, would be in federally insured, money brokered funds. This projection was intended to demonstrate the magnitude of the threat to the funds. Chairman Gray's projection to the contrary, it is clear that insured brokered deposits will be less than $30 billion at the end of 1985.*

Merrill Lynch's experience in these markets suggests in fact that the overall rate of sales of brokered deposits has stabilized. (See Exhibit VII) After an initial period of growth, typical of new financial products, the volume of newly-issued brokered CDs is now approximately equal to the amount of brokered CDs maturing. In addition, an April 1985 study prepared by the chief economist of the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations (the "Barnard Subcommittee") found that brokered deposits in problem institutions rated 4 or 5 by the Bank Board as of March 31, 1984 were declining at a 20 percent annual rate.

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* In Exhibit VI, we contrast Chairman Gray's projection with Merrill Lynch's projection, made a year ago, that fully insured brokered deposits at FSLIC-insured institutions held by individual savers might reach $24 billion by December 1985. It should be noted that Merrill Lynch's projection did not include the approximately $5-6 billion of institutional insured brokered deposits which Merrill Lynch excluded from its projection because Merrill Lynch does not participate in this market.

During FDIC Chairman William Issac's testimony before the Senate Banking Subcommittee last month, Mr. Issac testified that brokered deposit legislation which had been introduced in the Senate (S.791) would be worse than no legislation, and that such legislation would "cost the FDIC hundreds of millions of dollars easily, if not billions of dollars". Chairman Issac's prediction is difficult to reconcile with the finding of the September 1984 report issued by the Barnard Subcommittee that "brokered funding is declining dramatically as a factor in recent bank failures".

Results of Studies on Deposit Brokerage. The avowed purpose of the agencies in promulgating the Invalidated Rule and in their efforts to obtain increased regulatory authority has been to protect the deposit insurance funds from the risks perceived to be posed by deposit brokerage.

However, the September 1984 report by the Barnard Subcommittee as well as the April 1985 study prepared by the Barnard Subcommittee's chief economist cast serious doubt on the view that deposit brokerage poses a threat to the funds. Among the findings reached in the April study were that (i) among commercial banks, abusive use of brokered funds is generally limited to small institutions, (ii) as indicated above, brokered funding was declining "dramatically" as a factor in recent bank failures, (iii) with respect to savings and loans, the regulators can control excessive brokered funding growth by problem institutions through supervisory means alone, without imposing harsh new regulations or legislation, and (iv) the Board, in response to a Subcommittee request, failed to find any systematic difference between cases of problem institutions that relied upon brokered funding for their growth and those that did not, except that so-called "linked financing" (situations where a money broker might suggest or require that the proceeds of brokered funds be put to specified uses) appeared to be present in several brokered funds cases.

The agencies, and the FDIC in particular, would probably disagree with the foregoing conclusions despite the fact that they supplied the data used in the analyses. The FDIC continues to overstate the amount of fully insured CDs, erroneously including largely uninsured (over $100,000) CDs from the institutional market.

Indeed, it is almost impossible to reconcile the public statements of the FDIC with the conclusions that have been reached by the Comptroller of the Currency. The Comptroller stated in a letter to the Barnard Subcommittee that

> [B]rokered funds are but one element normally utilized to fund a large bank. Even before any difficulties arose in these banks brokered deposits were used as a regular source of funds . . . In this population, we could uncover no example where brokered funds contributed to or exacerbated the problems that led to the eventual downgrading of a bank's ratings. In fact, some of the banks' liquidity problems were eased by the prudent and [judicious] use of brokered funds... for the population of banks defined by the Subcommittee and used in this response, we can state for the record that there was no evidence of a systematic problem related to the imprudent deployment of brokered funds... It is not in the best interests of the banking system to eliminate brokered deposits as a viable source of funds.

The FDIC's conclusions are also at variance with the following conclusion drawn by the Barnard Subcommittee:

> The figure of "$9+ billion" that has frequently been cited by the FDIC as the amount of brokered funds in "troubled" banks (CAMEL-rated 3, 4 or 5) has no meaning or relevance as an indicator of the size of the brokered funds problem. As of September 30, $8 billion of this amount was held by 13 or 14 large national banks whose "troubled" classification had nothing to do with their reliance on brokered funding, according to the Comptroller of the Currency. Most of this $8 billion in brokered funds was uninsured anyway.

Moreover, attempts have been made by the FDIC to use faulty data, such as the "$9+ billion" figure cited above, to cast doubt on Merrill Lynch's evaluation process and suggest that Merrill Lynch and other deposit brokers have placed large amounts of fully insured deposits with "troubled", "problem" or "weak and risky" institutions (based on the CAMEL scale).

Merrill Lynch considers the banks that it represents in both the insured and uninsured markets to be viable, creditworthy institutions. While we have not and cannot respond to charges relating to CAMEL ratings -- since these are not publicly available -- we do have a rigorous evaluation system of our own, which may not be identical to the supervisory system, but which allows us to assess an institution's viability.

For each of its potential issuers, Merrill Lynch conducts a credit review of regulatory and audited financial reports covering several years, and has discussions and visits with management to evaluate funding and lending policies and management capabilities. Merrill Lynch's credit rating procedures involve an analysis by a professional credit analyst of a number of financial categories concerning a particular depository institution. The analyst will study various financial ratios, compare them to industry averages and peer groups and look for trends over time. An institution will either be approved or rejected and, if approved, may be subject to volume and/or maturity restrictions. Merrill Lynch's evaluation process results in the rejection of more than half of all interested banks and thrifts.

In view of the rigor of our procedures and our excellent record to date, statements by the regulators linking Merrill Lynch with "weak and risky" depository institutions are completely unfounded. Of the over 360 bank and thrift failures since 1982 (when Merrill Lynch began its insured certificate of deposit program), there has been no instance of a bank or thrift failure involving Merrill Lynch and abusive use of brokered deposits. In fact, there has been only one instance in which an assisted merger involved an institution in which brokered deposits had been placed by Merrill Lynch, and those deposits were placed only at a time when that institution, First National Bank of Midland, was considered quite credit-worthy by the agencies and professional analysts and never after the institution's financial position had deteriorated. In addition, recent references to a failed bank in Puerto Rico as a bank for which Merrill Lynch brokered CDs are inaccurate. The deposits in question were neither brokered nor fully insured.

Finally, it is particularly difficult to reconcile the FDIC's statements with the fact that the majority of the banks that Merrill Lynch represents in the insured CD market are either directly rated or are subsidiaries of bank holding companies which are rated "A" or higher by nationally recognized rating agencies (namely, Standard & Poor's, Moody's and Fitch Investors Service). If the FDIC has any damaging information on a bank that contradicts these ratings, it ought to disclose specific information about specific institutions to the investing public and the brokerage community, and not obscure such problems in highly aggregated numbers and technical terms such as "problem" or "troubled", which serve only to confuse the investing public. Alternatively, if the FDIC regards public disclosure as undesirable, it could simply prohibit or carefully limit deposit growth of any kind at an institution failing to meet specified standards. As we have repeatedly informed the FDIC, neither Merrill Lynch nor the rest of the Wall Street dealer community want to be involved with any institution which is not creditworthy.

The agencies' conclusions also conflict with two recent studies by Cates Consulting Analysts, which analyzed over 360 bank and thrift failures from 1982 through June 1985. The Cates studies, conducted for Merrill Lynch, found that the causes of failure remain "asset quality risk" and "interest rate risk". Furthermore, the studies found that brokered deposit use is declining, that brokered deposits were not even present in the majority of recent failures and that other "purchased funds" far exceeded brokered deposits. (See Exhibit VIII).

A recent study of the thrift industry by four economists, including members of the Bank Board's staff, documents the serious problems in the industry and the implications for the FSLIC.* Brokered deposits -- in fact, deposits of any kind -- are discussed only briefly but are not cited as contributing to thrift insolvencies.

Further doubt about the agencies' conclusions arises from a November 1984 Federal Reserve Board research paper entitled "Brokered Deposits and Bank Soundness: Evidence and Regulatory Implications." Although it found a correlation between the use of brokered funds and weak financial performance, the paper (i) acknowledged that "of course, correlation does not prove causality", (ii) devoted a significant amount of coverage to the benefits of brokered deposits, and (iii) found that most brokered funds in savings and loan associations did not appear to be held in accounts designed to maximize insurance benefits.

Authority to Curtail Deposit Expansion. While unrestrained deposit growth by weak institutions making imprudent asset decisions increases the exposure of the insurance funds, insured deposit brokerage in and of itself does not. There are numerous examples of weak banks and thrifts excessively stimulating deposit growth by means other than deposit brokerage. For example, banks and thrifts can raise deposits rapidly by offering above-market rates in their local areas and by using direct mail, telemarketing or advertising to attract out-of-state funds.

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* "Insolvency and Risk-Taking in the Thrift Industry: Implications for the Future", J.R. Barth, R.D. Brumbaugh, Jr., D. Sauerhaft, and G.H.K. Wang.

The agencies' current regulatory authority provides the regulators with more than adequate authority to curb unwise deposit growth -- including the improper use of the brokered deposit market -- and the agencies should utilize this authority. With respect to the Board, the Barnard Subcommittee's staff study noted that "there is room for major improvement in the enforcement of existing Bank Board rules". The FDIC, according to the statement delivered by Chairman Isaac last month before the Senate Banking Subcommittee, has for some time prohibited institutions which are rated 3, 4 or 5 on the CAMEL scale and against which the FDIC has taken enforcement actions from accepting further brokered deposits.* Given these facts, one wonders why the agencies continue to press for the abolition of insured deposit brokerage.

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* It should be noted that Merrill Lynch is not aware of any violation of this prohibition by any institution for which it brokers deposits.

Causes of Bank and Thrift Failures. The FDIC and the Board often cite instances in which recently-failed depository institutions have a higher-than-average percentage of brokered deposits. What the agencies fail to point out is that these are isolated cases in which almost all the brokered deposits are short-term deposits obtained from institutional investors participating in the institutional insured market described earlier.

Moreover, the FDIC and the Board have failed to recognize that it is not deposit brokerage which is the culprit in these cases but rather mismanagement, and in some cases, fraud. Over the last year several studies have found no causality between brokered funds and bank or thrift failures.

B. Deposit Brokerage is Consistent with the Insurance Acts

In promulgating the Invalidated Rule, the FDIC and the Board stated that deposit brokerage is an "outright misuse of the federal deposit insurance system" and that deposit insurance "was never intended to protect investors seeking the highest yields available in money markets." This idea, that somehow deposit brokerage is a perversion of the intent of Congress when it established deposit insurance, has been at the root of the agencies' continuing efforts to curtail deposit brokerage activities. However, the legislative history of the Federal deposit insurance acts reveals that, contrary to the position taken by the FDIC and the Board, brokerage of insured deposits serves the very purposes for which the Federal deposit insurance system was established.

Purposes of Deposit Insurance. The legislative history of Federal deposit insurance reveals that deposit insurance would serve three primary purposes. First, deposit insurance is intended to promote confidence in the banking system in general in order to attract as many deposits as possible to banks and thrifts. Second, while deposit insurance is intended to attract deposits to the banking system in general, we believe that Congress has been particularly concerned with maintaining public confidence in, and attracting deposits to, small- and medium-sized depository institutions. Third, deposit insurance is intended to protect individual depositors from suffering losses of their savings.

Deposit brokerage is consistent with all three purposes underlying the Federal deposit insurance system.

Deposit brokerage of insured deposit instruments clearly serves the purpose of attracting depositors to depository institutions. It has been our experience that a significant portion of the funds raised by nationally recognized brokerage firms has come directly from money market funds and other investment vehicles made available by brokerage firms. Thus, deposit brokerage of insured deposits has provided net new funds to banks and thrifts.

As discussed above, deposit brokerage activities have also provided many benefits to small- and medium-sized banks and thrifts. Primarily, these benefits are access to a national deposit market, access to medium- to long-term deposits and increased competition with money center banks.

With respect to the protection of depositors, it is important to note that many individuals have deposited funds with banks and thrifts through deposit brokers. These individuals are precisely the type of depositors Congress intended to be protected by the deposit insurance legislation. Thus, we believe the brokerage of deposits is consistent with the Congressional purpose of protecting depositors.

Insurance on High Yield Deposits. In promulgating the Invalidated Rule, the agencies stated that "deposit insurance was never intended to protect investors seeking the highest yields." The legislative history of the deposit insurance acts, however, provides no support for this assertion. Rather, to the limited extent that the legislative history deals with the question of whether depositors seeking high yields on deposits should be entitled to deposit insurance, the legislative history supports the availability of insurance to those depositors. The language of the District Court's decision, in overturning the Invalidated Rule, also supports this conclusion.*

The recent deregulation of interest rates effected by the DIDC, acting pursuant to a Congressional mandate, indicates that Congress intended to accord deposit insurance to individuals seeking money market rates. Indeed, one of the purposes of the deregulation legislation (and DIDC actions taken pursuant thereto) was to enable depositors to shop for insured account rates that were competitive with rates being paid by money market funds.

For some reason, the agencies have expressed the view that persons who utilize a brokerage firm to place deposits are "investors" and not depositors and, as brokerage firm customers, do not merit insurance. However, anyone who deposits money in a depository institution, whether directly or through a brokerage firm, is a depositor. The individuals who make their deposits through brokerage firms are entitled to the same deposit insurance coverage as persons making deposits directly with depository institutions.

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* In reaching his decision, Judge Gesell stated "It is clear, therefore, that the statutes were intended to grant to each depositor federal insurance up to the statutory ceiling..." (Emphasis not added).

"Marketing" of Deposit Insurance. The agencies have also, from time to time, deplored the "marketing" of deposit insurance by brokers. Evidently there is a basic belief by the agencies that deposit brokers should not be able to offer an instrument which is federally guaranteed.

Of course, this notion is unfounded. For decades, intermediaries such as brokerage firms have been making a market in government or government guaranteed obligations, such as Treasury Bills, Government National Mortgage Association obligations and Federal National Mortgage Association obligations.

Somehow the agencies have seemingly become convinced that the brokerage firm is reaping the benefits of deposit insurance. Yet the brokerage firm neither gets the deposited funds -- which go to the depository institution -- nor the deposit insurance -- which, of course, goes to the depositor. The brokerage firm merely brings depositor and depository institution together and charges a fee, like any other intermediary, for its services.

Statutory Authority. The District Court decision overturning the Invalidated Rule and the affirmation of that decision on appeal confirmed the correctness of our view that the promulgation of the Invalidated Rule exceeded the agencies' authority. Congress alone has the power to effect changes of the type contemplated in the Invalidated Rule. The reason we are here today is to support Congressional efforts to address the deposit brokerage issue in a reasonable and constructive fashion.

V. Alternatives Before the Congress

As stated above, we believe there have been abuses in the insured brokered deposit market by weak institutions and by unregulated brokers that deal almost exclusively with institutional investors. Such abuses can be prevented by prudent legislative action addressed to those activities that result in abuse, rather than those activities that provide the benefits we have detailed in this Statement. H.R. 107, introduced by Congressmen Garcia, Schumer and Barnard on January 3rd, strikes an appropriate balance between preventing abuses and preserving the benefits of deposit brokerage.

A. Objectives of Prudent Legislation

Prudent legislation in this area should have the following objectives:

Limit the Amount of Short Term Brokered Funds Any Institution Can Accept. Legislation addressing the brokered deposits issue must take into account the fundamental distinction between short-term and medium-term brokered deposits. The market for short-term brokered deposits differs substantially from the market for medium-term brokered deposits, just as the markets for short-term and medium-term certificates of deposit differ generally.

The market for medium-term brokered deposits consists primarily of individual depositors. Deposit brokers serving the medium-term market are mostly national multiservice brokerage firms with substantial capital bases. Such firms have invested billions of dollars over many years in order to develop a large base of individual customers. Such firms reinvest considerable amounts of funds in order to develop the substantial capital bases which allow them to hold positions in, and to maintain secondary markets for, certificates of deposit. Because the ability to offer secondary market capabilities is a necessary part of brokering medium-term certificates of deposit, the national brokerage firms must of necessity establish credit review processes in order to enter into secondary market transactions without jeopardizing the firms' capital.

The market for short-term deposits is predominantly institutional in nature. Deposit brokers serving the short-term market typically lack a substantial capital base. Because of this limitation, such firms are unable either to provide an adequate market in the obligations they broker or to spend the large sums necessary in order to establish a large individual customer base. Many of the institutional customers served by deposit brokers in this market are subject to legal restrictions limiting the maturities of the obligations which they are authorized to acquire.

The distinction between short-term and medium-term deposits in the brokered deposit area merely reflects long-standing distinctions with respect to certificates of deposit generally which have historically been recognized by the bank regulatory agencies. For example, the Board of Governors of the Federal Reserve System, in Regulation D, distinguishes between short-term (under 18 months) and medium term (18 months and over) deposits in the reserve requirements it imposes on depository institutions.* As another example, the DIDC recognizes the distinction between short-term and medium-term deposits in the early withdrawal limitations it imposes on depository institutions, with different penalties accruing based on whether the certificate of deposit has a maturity of one year or greater, or less than one year.**

The differences in the short-term and medium-term brokered deposit markets are evidenced in the pattern of abuses than can be associated with the two markets. The greatest abuses occur when depository institutions accept large amounts of brokered deposits that have maturity dates of less than one year. It has been suggested that this compels the institution to obtain a relatively quick return on its money in order to pay back the deporits, plus interest, and make a profit and that the types of investments providing a quick return may be risky and unsound. On the other hand, medium- and long-term deposits allow the institution to fund its medium- and long-term assets, such as housing loans, while giving the institution a stable deposit base.

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* See 12 C.F.R §204.9

** See 12 C.F.R §1204.103

H.R. 107 would limit the short-term brokered deposits a healthy depository institution could accept to the lesser of 15% of total deposits or 200% of the institution's unimpaired capital and surplus. This limitation would directly tie the amount of short-term brokered deposits an institution could accept to its financial health.

Prohibit Weak Institutions from Abusive Use of Deposits. Financially weak institutions should be denied access to the insured short-term brokered deposit market. Such institutions may not have the capability to absorb and carefully invest short-term brokered funds.

H.R. 107 would resolve this problem by prohibiting institutions whose unimpaired capital and surplus is less than 3 percent of their liabilities from accepting any short-term brokered deposits.* In addition, H.R. 107 contains several well-crafted provisions that would have the effect of preventing institutions which are denied access under the bill to short-term brokered deposits from replacing such funds by drawing on the medium-term market. The bill denies insurance to several classes of institutional depositors, such as credit unions, banks and thrifts, that have "spread" deposits to maximize deposit insurance. Furthermore, the bill would limit the amount of insurance available to a depositor placing funds in one or more institutions through a deposit broker to $100,000 for any four-year period and would limit to 5% of the total deposits maturing in any one-year period the amount of insured deposits that can be placed by a single deposit broker in an institution. The $100,000-per-four-year insurance limitation will ensure that depositors placing funds in excess of $100,000 and deposit brokers who place such sums will evaluate the creditworthiness of institutions instead of relying on deposit-spreading.

In sum, H.R. 107, through its checks and balances, provides significant protection against the abuses of brokered deposits by weak institutions.

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* Merrill Lynch might suggest only one modification of this provision; namely, changing the amount of capital a bank must have in order to accept brokered deposits from the 3%-of-liabilities standard established in H.R. 107 to an amount more consistent with the current capital standards established for banks.

Prohibit Discrimination Against Holders of Brokered Deposits. In order to ensure that deposit insurance is extended to brokered deposits consistent with the mandates of the deposit insurance laws, the FDIC and the Board should be prohibited from discriminating against brokered deposits in providing deposit insurance. Such a prohibition would prevent the implementation of regulations like the Board's proposed recordkeeping rule which, in effect, imposes unreasonable and unrealistic requirements designed to make deposit brokerage uneconomical.

B. Other Alternatives

There are other proposals for regulating the brokered deposits market. One such proposal, incorporated by Congressman Wylie in H.R.15, would place a cap on the acceptance of insured brokered deposits at 5% of total deposits. Such a proposal fails to make the critical distinction between short-term and long-term brokered deposits and, thereby, effectively denies sound depository institutions the benefits of brokered deposits with maturities of more than one year when these deposits have not been associated with any abuses or problems. Furthermore, while any cap is necessarily arbitrary, a 5% cap is unrealistically low, even if the cap is on short-term brokered deposits alone.

The Board has also proposed legislation addressing brokered deposits. Its proposal, embodied in H.R. 1680, would provide the Board with authority to establish classes of accounts and determine which classes are entitled to deposit insurance. In the accompanying analysis of its proposed legislation, the Board makes clear that the legislation is designed to give it the authority to promulgate the Invalidated Rule. We strongly oppose any legislation that would give the Board or the FDIC authority to eliminate insurance of brokered deposits. The destruction of the deposit brokerage market, which would be the result of eliminating insurance, would be harmful to all depository institutions in this country and to the consumers they serve.

Similarly, on June 12, the House Banking Committee reported out a bill, H.R. 20, that contains a provision which we believe has the unintended effect of providing the Board authority to promulgate a rule such as the Invalidated Rule. Section 4(e) of H.R. 20 would grant to the Board broad authority to prohibit insured thrift institutions from engaging in any business activity which, in the Board's view, is "an improper incident to the operations of insured" thrift institutions. Mr. Chairman, in your Additional Views with Congressman Parris contained in the Report accompanying H.R. 20, you observe that pursuant to this language "activities may be prohibited even if they do not raise concerns about the safety of deposits or the risk to the federal insurance fund". We agree with you that this language provides "unbridled discretion" to the Board and constitutes an unfortunate "departure from existing law". We urge that this provision be amended when H.R. 20 is brought before the House of Representatives for consideration.

A final approach to regulating the brokered deposit market would be to do nothing. We believed for a long time that application of the current statutes, combined with effective enforcement action by the two agencies, would have been the best solution. However, in view of the agencies' efforts to curtail deposit brokerage such as the Invalidated Rule and the Board's recordkeeping rule, we believe that legislative action is necessary to preserve brokered deposits. Accordingly, we support the adoption of reasonable legislative alternatives, such as H.R. 107, which would control any abuses that may exist while preserving the many positive aspects of deposit brokerage.

VI. Conclusion

Merrill Lynch recognizes that there are some abuses associated with the improper use of brokered deposits. To deal with these abuses, Merrill Lynch urges the Congress to adopt legislation such as H.R. 107 which would, first, limit to a reasonable level the amount of short-term insured brokered deposits per depository institution; second, limit the access of weak depository institutions to brokered deposits; and, third and most important, prohibit the agencies from adopting any rules which would discriminate for deposit insurance purposes against depositors who rely on an intermediary such as a deposit broker.

These recommendations are workable and would deal effectively with the specific problems in the market while eliminating any conceivable threat to the insurance funds from deposit brokerage activities. They would also preserve the rights of individual savers and the benefits of brokered deposits for well-managed banks and thrifts and for the economy as a whole.

In closing, I would like to say that Merrill Lynch shares the agencies' concerns about the safety and soundness of financial institutions and the integrity of the insurance funds. We are also deeply concerned about abusive use of brokered deposits by weak institutions. However, as we have just discussed, brokered deposit use is down while failures are up. We believe it is time to resolve the brokered deposits controversy and focus on the important tasks of preventing failures, increasing the soundness of depository institutions and strengthening the insurance funds.

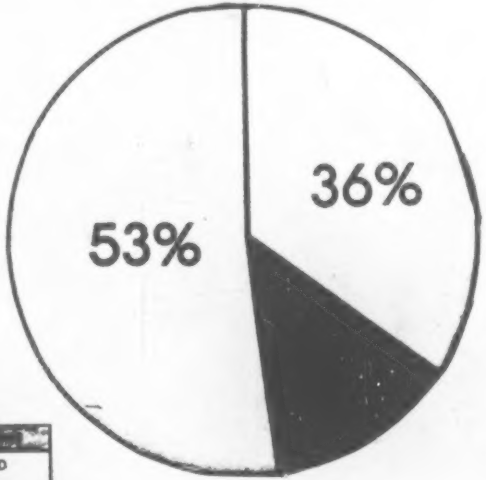
Merrill Lynch hopes that this Statement will help the House in its consideration of legislation addressing the brokered deposit market.

EXHIBIT I

THE BROKERED DEPOSIT MARKET

TOTAL BROKERED DEPOSITS

$88 BILLION AT BANKS AND THRIFTS
DECEMBER 1984



INDIVIDUAL INSURED SEGMENT	
ISSUERS:	LARGE, MEDIUM SIZE AND SMALL BANKS AND THRIFTS
DEALERS:	NATIONAL BROKERAGE FIRMS
CUSTOMERS:	INDIVIDUAL SAVERS INCLUDING IRA/KEOGH ACCOUNT HOLDERS
CREDIT REVIEW:	CAREFUL REVIEW BY BROKER-DEALER
AVERAGE MATURITY:	OVER 3 YEARS
OUTSTANDINGS:	$32 BILLION

[illegible]	
ISSUERS:	LARGE BANKS AND THRIFTS
DEALERS:	MONEY CENTER BANKS AND NATIONAL BROKERAGE FIRMS
CUSTOMERS:	LARGE INSTITUTIONAL INVESTORS
CREDIT REVIEW:	CAREFUL REVIEW BY BOTH DEALER AND INVESTOR
AVERAGE MATURITY:	90 DAYS
OUTSTANDINGS:	$46 BILLION

[illegible]	
ISSUERS:	SMALL BANKS AND THRIFTS
DEALERS:	UNREGISTERED "MONEY BROKERS"
CUSTOMERS:	MEDIUM AND SMALL INSTITUTIONAL INVESTORS
CREDIT REVIEW:	NONE USUALLY
AVERAGE MATURITY:	90 DAYS
OUTSTANDINGS:	$10 BILLION

SOURCE: MERRILL LYNCH ESTIMATES AND ANALYSIS.

EXHIBIT II

MERRILL LYNCH CORPORATE CREDIT STANDARDS

CORPORATE CREDIT STANDARDS*
INSURED RETAIL CERTIFICATES OF DEPOSIT

I. It is Merrill Lynch's policy to deal only with depository institutions deemed appropriate according to the following standards:

  A. Review of the institution's financial condition and management indicates

    1. for all issuers, strong near-term viability, and

    2. for issuers of longer-term deposits, no clear, present threat to longer-term viability.

  Institutions exhibiting rapid growth of risk assets are generally considered unfavorably.

  B. The institution's franchise is such that, in the event of a failure, an assumption of liabilities is more likely than liquidation.

II. Review of each institution includes:

  A. Collection of regulatory and audited financial reports covering a period of the last several years up to the most recent calendar quarter, plus other data as may be required by the Corporate Credit Analyst.

  B. Analysis of:

    1. capital adequacy (which includes review of the level and trend of capital ratios, as well as the composition of capital);

    2. profitability (which includes not only the level but the quality and trend of earnings as well as review of the components of earnings and near-term earnings prospects);

    3. asset quality (which includes not only review of current problems but also the analyst's view of possible changes in asset quality based on (a) composition of and changes in portfolio mix and (b) general economic conditions);

    4. liquidity (which includes a review of liquid assets as well as types and stability of funds sources);

    5. the institution's exposure to interest rates;

    6. the length of time the institution has been in business, and the length of time current management/ownership has been in control;

    7. the size of the institution, since larger companies

      (a) are less likely to be overwhelmed by local economic factors,

      (b) are less likely to change radically the nature of their business,

      (c) have greater flexibility should problems occur, and

      (d) are more likely to receive needed regulatory attention in a crisis.

  C. Discussions with management covering key management policies, e.g., with respect to loan review, liquidity, asset-liability management, and key strategies, e.g., for expansion into new markets.

  D. Statement from management as to use of proceeds.

III. Corporate Credit will place a limit on the amount of deposits to be placed depending on the overall quality of the institution, the distribution of maturities and the use of proceeds.

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* Excerpted from internal Merrill Lynch Corporate Credit Policy Bulletins.

EXHIBIT III

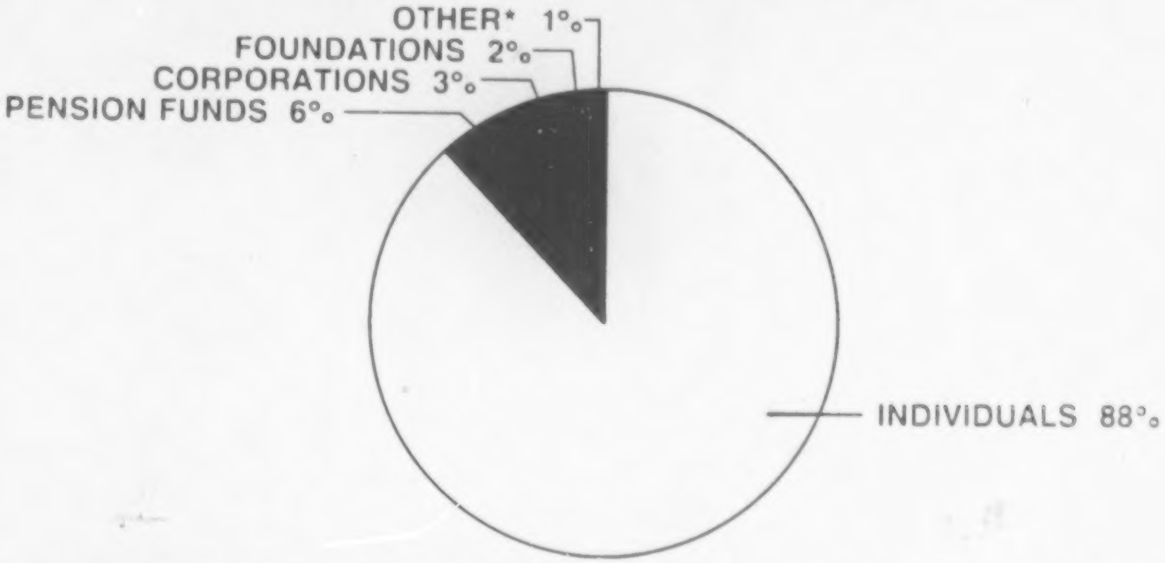
MERRILL LYNCH RETAIL CD PROGRAM

DISTRIBUTION OF CD BUYERS BY TYPE

MERRILL LYNCH RETAIL CD PROGRAM

DISTRIBUTION OF CD BUYERS BY TYPE

100% = 13,838 TRANSACTIONS



SOURCE: MERRILL LYNCH ANALYSIS OF TRADES FOR THE FIRST TWO WEEKS OF MAY 1985

* INCLUDES BANKS, INSURANCE COMPANIES, OTHER DEALERS.

Presumably, once the risky institution has been identified, the regulators can decide whether its problems will be aggravated or ameliorated by continued access to brokered funds. If the institution suffers from a tendency to misallocate assets, it may be determined that reliance on brokered deposits will only aggravate these difficulties. In that case, the firm can be denied access to the funds.

Blunderbuss Thinking

Regulators have a tendency to propose blunderbuss solutions to problems. "If some institutions misuse brokered deposits, then let's eliminate deposit brokerage," many are implicitly saying. Should the public embrace such a solution? One hopes that it won't.

Killing the institutional market in brokered insured deposits may serve legitimate public-policy objectives. Killing the noninstitutional market does not. Destroying a market — primary and secondary — that has benefited both savers and institutions and may prove of much greater assistance in the future is hardly the appropriate way to handle isolated cases of abuse.

Such abuses can and should be handled on a case-by-case basis. The FDIC-FHLBB proposal for limitation of insurance coverage on brokered deposits should be summarily rejected. ■

EXHIBIT IV

AMERICAN BANKER REPRINTS

MARCH 20, 1984 "IN PRAISE OF BROKERED DEPOSITS"

FEBRUARY 26, 1985 "REFOCUSING ON BROKERED DEPOSITS"

American Banker
The Only Daily Banking Newspaper
VOL. CXLIX NO. 56
Tuesday, March 20, 1984
149th Year

Comment

In Praise of Brokered Deposits

By SANFORD ROSE

The FDIC and the FHLBB want to restrict to $100,000 the insurance coverage on deposits placed by or through a deposit broker at a single depository institution, regardless of the number of beneficial owners of those deposits. This per broker, per institution limit would obviously kill the market in brokered insured deposits. Some regulatory agencies apparently think that this is desirable. But they are gravely mistaken.

The total brokered deposit market, estimated at around $80 billion, consists of three components: 1) the institutional market in uninsured CDs; 2) the institutional market in insured CDs; and 3) the noninstitutional market in insured CDs. Component one — the brokerage of over $100,000 CDs — would be largely unaffected by the FDIC-FHLBB proposal. Components two and three would be affected.

It may be legitimate to choke off the institutional market in insured CDs, estimated at around $6 billion. That market is run by unregulated brokers who slice up the deposits of wholesale investors into bundles of $100,000 or less and parcel these out to hungry banks and thrifts. One can legitimately argue that this is a misuse of deposit insurance, which was never intended to benefit large investors just because they may be nimble enough to subdivide their holdings.

What's more, it has been established that the brokers operating this market do little or no credit analysis. This is a somewhat irrelevant but nonetheless highly emotive point. The fact that an intermediary will accept CD issuers solely on the basis of yield and without assessing their soundness conjures up an image of insouciant greed that predisposes the public to accept regulation.

However, the attempt to lump brokers who serve the needs of institutional investors with those who serve the needs of retail savers makes no sense at all. The noninstitutional insured part of the brokered deposit market, estimated at around $16 billion, is populated with registered brokers who profess to do adequate credit analyses and whose activities are not in the least inconsistent with the objectives of the deposit insurance system.

Performing a Classic Chore

Brokers of retail CDs — chiefly Merrill Lynch, which has placed over $10 billion in paper within the last year — perform the classic role of helping to liberate individual savers from the confines of geography. They move funds from capital surplus to capital deficit areas, offering savers from the isolated regions the opportunity to earn somewhat higher returns than are available locally.

For example, the average rate on one-year CDs brokered by Merrill in the fourth quarter of 1983 was higher than that posted by the major banks in such capital surplus areas as Chicago, Detroit, and Philadelphia.

Additionally, the insured CD broker offers the saver a wider choice of maturities than he currently enjoys. Because of its extensive institutional coverage, a broker like Merrill can provide the saver with maturity options extending out as long as 15 years and often unavailable from banks and thrifts in his local area.

Brokerage can also broaden product options. The zero coupon CD is a superior investment vehicle. It is, in fact, the only form of long term bank deposit that provides a guaranteed yield. That's because there is no interest withdrawal and the return is compounded at the promised yield until maturity.

Savers desirous of purchasing zero coupon CDs frequently can't find banks or thrifts that offer them. Merrill Lynch has identified a number of institutions that understand the need for zero coupon vehicles, and it can therefore accommodate knowledgeable customers.

(Approximately 8% to 10% of the more than $10 billion in CDs Merrill Lynch brokered in the last year have been in zero coupon form. The face amount of these CDs, as opposed to their discounted amount, approaches $2.5

A Glimpse of Future Benefits

The case of the zero-coupon CD suggests how important deposit brokers may eventually become — provided the regulators don't kill the market. The zero, of course, provides advantages to issuers as well as to savers. Since there is only one cash flow, paid at maturity, the zero has a duration that is exactly equal to its maturity.

Many bank and thrift assets, however, have multiple cash inflows. Since the present value of the later cash inflows is much less than that of the earlier cash inflows, the composite durations of these assets are appreciably shorter than their maturities.

Banks and thrifts are beginning to realize that they can make long-term fixed-rate loans with deposits of much shorter maturity than the loans — without assuming interest risk. That's provided the duration — not the maturity — of the assets approximates the duration of the liabilities.

Since a 30-year fixed-rate mortgage made at today's rates has a duration of around five years, it must be funded with a CD of similar duration. And since zero-coupon CDs have durations that are identical to their maturities, a 30-year mortgage can be funded safely with a five-year deposit, provided that deposit is a zero-coupon instrument.

Now, even when a bank or thrift catches on to this fact, it often cannot capitalize on it because of marketing limitations. It may require considerable advertising dollars to acquaint savers in any given area with the virtues of the zero-coupon instrument. The local institutions may not be able to spend those dollars.

Merrill Lynch can, and it also has a clientele of sophisticated savers who very often don't need much persuading. So Merrill and its competitor brokers are logical handmaidens of the banking and thrift industry. Their capacity to tap funds from a variety of sources may enable institutions in even the most isolated areas to reintroduce the long-term fixed-rate loan that is retained in portfolio yet does not increase the institution's interest rate exposure — provided the duration match of the portfolio is continuously monitored.

Virtues of the Secondary Market

The deposit broker contributes to the institution's capacity to service the demand for fixed-rate credit is still another way. Brokers like Merrill Lynch make a secondary as well as a primary market in retail CDs. The primary CDs that the firm brokers are negotiable, but they are not redeemable before maturity. Hence if the saver wants to get to cash, he must sell the instrument back to Merrill, garnering a profit if rates have fallen since his purchase or a loss if rates have risen.

Relatively few savers have thus far made use of secondary-market facilities. But if banks and thrifts imposed realistic premature withdrawal penalties — say, forfeiture of as much as one year's interest on a multiyear CD instead of today's nugatory penalties, which in effect give the saver a "par put" on the issuing institution — customer interest in using the secondary market would, of course, be heightened.

Consider the consequences of what might happen if banks and thrifts began imposing realistic penalties for premature withdrawal. The institutions would be reasonably sure that long-term funds, once acquired, would remain long term, regardless of what happened to interest rates. Instead of redeeming their CDs at the institutions of issue, savers would use the secondary market whenever they wanted to get to cash. No matter how many times a long-term instrument was sold and resold in that market, it would remain the obligation of the issuing institution.

Secure in the knowledge that their longer-term funds cannot suddenly be transformed into shorter-term obligations, depository institutions would become far more disposed to extend long-term credit than they now are. The needs of borrowers would be better served than is now the case, while the saver would still be afforded the opportunity to liquefy his holdings.

The price the saver pays for liquidity would depend on how quickly he moved. Conceivably, savers would soon become acclimated to moving with great celerity, taking small losses when rates rose and small profits when rates declined.

The FDIC-FHLBB proposal to limit to $100,000 the insurance coverage on deposits handled by a given broker for a given institution would eliminate the secondary as well as the primary market in brokered insured deposits. And since in the opinion of many, depository institutions are precluded from making a market in their own time deposits, the proposal would effectively nullify the negotiability option on retail CDs granted to depository institutions by the DIDC two years ago.

The FDIC-FHLBB initiative would therefore weaken the profit potential of many institutions and decrease the overall efficiency of financial intermediation. One would have to assume that the regulators have very compelling motives for taking such a step. But is that in fact the case?

Presumably, the regulators want to prevent poorly run institutions from acquiring through brokerage the deposit wherewithal to expand footings and thus increase the risk to the insurance funds. That sounds like a perfectly sound objective, but surely it can be achieved by other methods than the destruction of the market in brokered insured funds.

The deposit brokers are perfectly willing to report to the regulators on a monthly or even a weekly basis, advising as to which institutions have received what amount of funds. If the regulators are reluctant to sanction the growth of certain institutions that might misallocate brokered funds, then they can quite simply order the affected banks and thrifts not to acquire those funds.

Can the regulators identify potential regulatory risks far enough in advance? Of course they can — or at least they should be able to make such a determination.

The regulators are cutting back on the number and frequency of examinations of sound depository institutions in order to concentrate their manpower on those that are potential risks. Computer surveillance — or remote analysis — identifies these institutions, while on-site examination confirms the nature and magnitude of the problems.

Notes David Cates of Cates Consulting Analysts: "My firm has been successful in identifying — not with absolute certainty but nevertheless with a high degree of certainty — what institutions are likely to fail in the foreseeable future, and for what reasons. If we can do this, then the regulators ought to be able to do the same — at least as well as we can, if not better."

Reprinted from

American Banker

The Daily Financial Services Newspaper

February 26, 1985

Comment

Refocusing on Brokered Deposits

By SANFORD ROSE

As a famous legislator once quipped: "Don't blame you! Don't blame me! Blame the man behind the tree!" Today the man behind the tree is the deposit broker, the favorite whipping boy of a goodly number of panicky regulators, bemused congressmen, and credulous journalists. Many would curtail or even ban the brokered deposit, which is said to have contributed to the failure of countless financial institutions.

The palpable falsity of this proposition is demonstrated in a recently released study by Cates Consulting Analysts of New York. The study examines the reasons for failure at the 60 commercial banks and some 16 savings and loans that folded between January 1 and Sept. 30, 1984. Particular attention is paid to the role of brokered deposits in these 76 failures.

Of the 60 commercial banks that failed in the first nine months of last year, 37 (63%) had no brokered deposits whatsoever. Of the 23 that used brokered funds, nine employed them so sparingly that they could not have played any measurable part in the collapse of these institutions. The median ratio of brokered money to total deposits at these banks amounted to less than 7%.

Six failed banks made moderate use of brokered funds — 20% or less of total deposits. Only eight banks — 13% of those that went belly-up during the period — might be described as immoderate gatherers of brokered funds, with usage amounting to more than 20% of total deposits. And only two of these eight banks were brokered-funds hogs, taking more than 37% of their total deposits out of the brokered-funds market.

There were 17 failures of savings and loans from January 1 to September 30 of last year. Data are available on 16 of these unfortunate institutions. Ten of the S&Ls had no brokered deposits at all. Of the six that used brokered funds, two got less than 2% of their total deposits from brokers, one obtained 19% of its money in this form, and in only three cases was the ratio of brokered to total deposits greater than 20%.

Other Money Could Be Had

The most significant datum in the Cates study concerns the ratio of brokered funds to all forms of purchased money. The brokered deposit, whether retail or wholesale, bears some of the characteristics of purchased money. Brokers of retail funds generally aggregate retail deposits and place the funds in institutions in units of $100,000. Those who deal in wholesale funds perform the reverse operation, disaggregating larger chunks of money and also placing them in units of $100,000. Thus nearly all forms of brokered money appear on balance sheets in the category of large liabilities — $100,000-and-over deposits.

As the Cates study points out, brokered funds represent only one category of large liabilities. Jumbo CDs, fed funds, repos, and commercial paper constitute the bulk of other types of purchased money.

Observes Ray Garea, an executive vice president of the Cates group and the author of the study: "If we find that significant levels of brokered deposits were present in a substantial number of 1984 bank failures, that does not necessarily support a conclusion that brokered deposits cause or were even related to such failures. If the banks that failed made excessive use of other types of purchased money, it would be inappropriate to focus on brokered funds alone as a cause of failure. Attempting to limit or eliminate the use of brokered deposits would have little effect if banks could merely shift to other forms of purchased money."

A glance at the Cates data reveals that this is precisely what would happen. Surprisingly, failed banks that used brokered deposits have had abundant access to other bought money. The ratio of brokered deposits to bought money at the 23 failed banks that tapped the brokered-funds market was only 37%. In other words, the users of brokered money were able to obtain 63% of their purchased-money requirements from nonbroker sources — ostensibly from unwary investors in their local markets.

Looked at from another vantage, the 23 failed banks with brokered deposits were excess users of bought money. They funded nearly 40% of earning assets with large liabilities. But only 13% of their assets were funded with the brokered-deposit component of bought money. The rest of the cash came from directly placed paper. Thus the evidence would seem to indicate that, absent brokered funds, these banks could have gone elsewhere to finance their shaky portfolios.

The same point can be made about the six failed S&Ls that made use of brokers. The ratio of brokered deposits to purchased funds at these institutions amounted to 48%. Clearly, thrift users of brokered money were able to obtain more than half of their total requirements from other sources.

Scrap the FHLBs!

Where did these six as well as the other 10 failed thrifts get the purchased money that financed an excessive portion of their earning assets? That's easy. They got a large chunk of it from their respective Federal Home Loan Banks. Purchased funds at the 16 failed thrifts financed around 30% of earning assets. The proportion of earning assets funded by FHLB advances at these institutions averaged nearly 14%.

Failed thrifts made considerably greater use of FHLB money than did healthier associations. The question might then be legitimately asked: If the regulators themselves provided the wherewithal for shaky associations to greatly expand their operations, how is it possible to single out for condemnation the deposit broker, who in some cases merely supplemented the effort of the governmental authorities?

Or as analyst Ray Garea puts it more piquantly: "If one wants to argue that a specific liability category causes S&L failures, then the solution is to dismantle the Federal Home Loan Bank System!"

But the obvious fact is that specific liability categories are not responsible for the demise of thrifts or for that of commercial banks either. The 16 savings and loan casualties of 1984 perished because they assumed even more interest rate risk than did their peers. As a result, their net interest margins and their book capital positions deteriorated more rapidly than was the case at those associations which still cling to life.

The 60 commercial banks that failed in 1984 did so because of problems of asset quality. In 1983, the median ratio of nonperforming loans to total loans at these 60 institutions was an astounding 11.44%. The ratio of chargeoffs to loans in 1983 was approximately 10 times greater in these 60 banks than it was for banks in general. Even in 1982, 40% of the 1984 failures had loan losses equal to or greater than 1.46% of total loans.

Walking Corpses

The conclusion is inescapable: Banks and thrifts fail because of their inability to manage credit risk and/or interest rate risk. The presence of absence of brokered deposits is largely irrelevant to their condition.

Indeed, in most cases, it can be shown that failed banks or thrifts were walking corpses long before they acquired significant amounts of brokered money, if, in fact, they did so. Consider two examples of 1985 failures that have recently been reported. Just this month, the $20 million-deposit Peoples Bank & Trust Co. of Wartburg, Tenn., and the $33 million-deposit West Valley Bank of Woodland Hills, Calif., were closed. Both banks were alleged to have acquired large amounts of brokered deposits to engage in speculative and shady deals — a phenomenon dubbed linked financing. The implication is that these institutions failed because of the relationship between brokered money and questionable or illegal enterprises. But nothing could be further from the truth.

The Tennessee institution posted losses of 3.64% on assets and and had chargeoffs equal to 6.30% of loans in 1983, at a time when its reliance on brokered money had not yet ballooned. Indeed, in that year large liabilities as a percent of earning assets was 21%, actually down from the 32% recorded in 1982.

Given its losses and an alarming drop in its capital ratio, the $20 million bank was experiencing terminal difficulties before it made the decision to acquire an estimated $8 million to $10 million in brokered funds. The decision to seek those funds was undoubtedly a desperate gamble designed to reverse the inevitable greased slide into oblivion.

The Cause Was Gluttony

The bank's real difficulties began when it overlent outrageously in 1980. In that year, commercial loans grew by a vertiginous 51%, and this was followed in 1981 by a further 40% explosion in the commercial loan portfolio.

The West Valley Bank lost 50 basis points on assets in 1983 and 40 basis points the year before. Its return on assets had been slipping since 1980. The bank recorded net chargeoffs equal to 2.17% of loans in 1981. After falling to 1.01% in 1982, chargeoffs climbed back to 1.51% in 1983. By 1982, the bank's other real estate owned as a percent of loans plus OREO had reached 4.52%.

Quite obviously, this institution was drowning in bad real estate loans. In 1980, the growth of nonretail loans amounted to an eye-popping 70%. Apparently, the bank had enormously expanded its commercial real estate portfolio at precisely the wrong time, reaching both for unsustained volume and for yield.

Interestingly, in 1983, West Valley's reliance on large liabilities was no greater than that of regional peer banks in the same size group, although dependence on purchased money had been greater in the past. But no one can reasonably argue that purchased or brokered money undid West Valley. The bank was already in extremis in 1983.

That year, it appears to have suffered a crippling loss of collected demand deposits, as strapped borrowers seemingly could not maintain the level of their compensating balances. Hence, they engaged in a continuous round of check writing, which inflated cash items in the process of collection and sharply reduced the bank's ratio of earning assets to total assets.

At West Valley, more than a third of reported assets did not earn a dime in 1983. Any bank that can't stop the hemorrhaging of investable demand balances is terribly ill. The fact that West Valley subsequently embarked on a madcap insurance scheme funded with brokered money is very nearly beside the point.

Slighted Virtues

Those who blame brokered money for the failure of depository institutions overemphasize the dangers and all but ignore the virtues of the brokerage function. Brokerage improves the efficiency of markets, and if allowed to flourish, may contribute to the ability of banks and thrifts to provide borrowers with long-term credit accommodations. (See "In Praise of Brokered Deposits," the *American Banker*, March 29, 1984.)

While there are some problems with unrestricted brokerage, these can for the most part be eliminated with minor reforms. It is simply idiotic, however, to link brokerage to the demise of depository institutions. The Cates study is a partisan document, to be sure. It was written for Merrill Lynch. But it is soundly researched, and its conclusion — that there is little, if any, causal connection between brokered funds and bank or thrift collapse — is unassailable. ■

EXHIBIT V

ONE YEAR CD

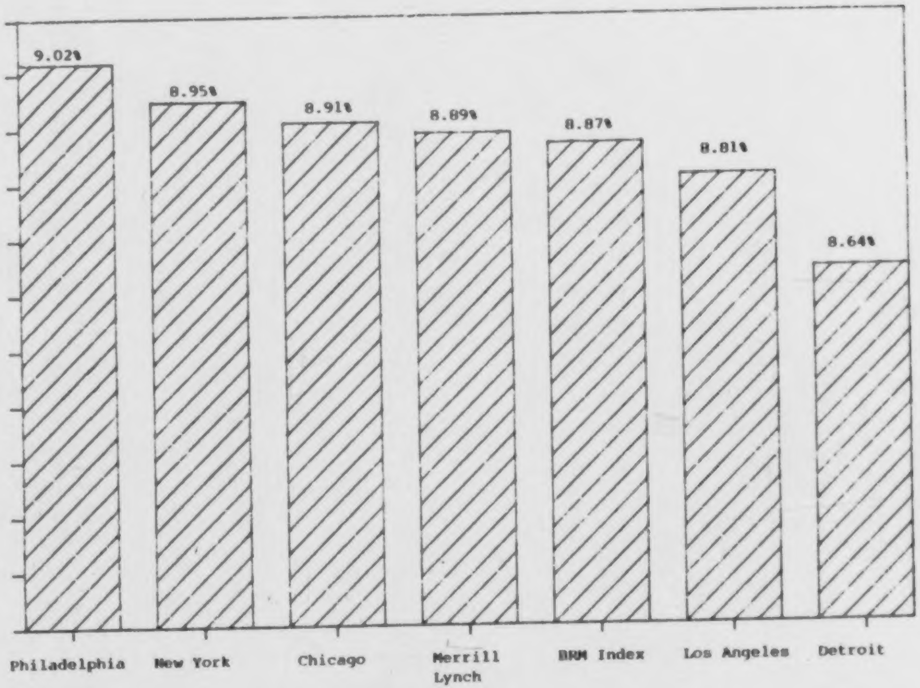
EFFECTIVE ANNUAL YIELD

MAY 1985 AVERAGE

ONE YEAR CD

EFFECTIVE ANNUAL YIELD

May 1985 Average

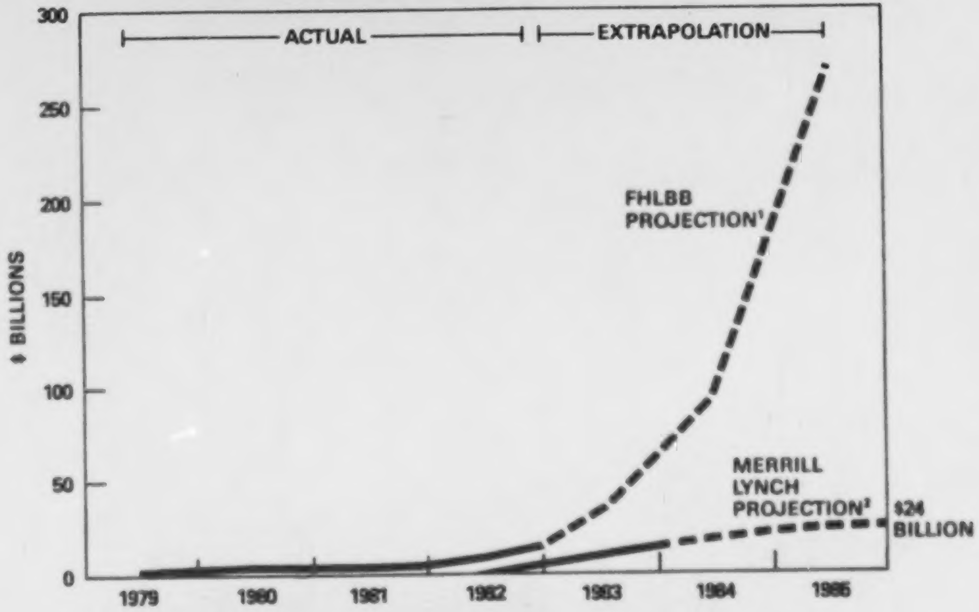


Source: Bank Rate Monitor, 4 weeks ended June 3, 1985; Merrill Lynch Analysis

EXHIBIT VI

COMPARISON OF FHLBB AND MERRILL LYNCH GROWTH PROJECTIONS

BROKER-ORIGINATED DEPOSITS AT FSLIC-INSURED INSTITUTIONS



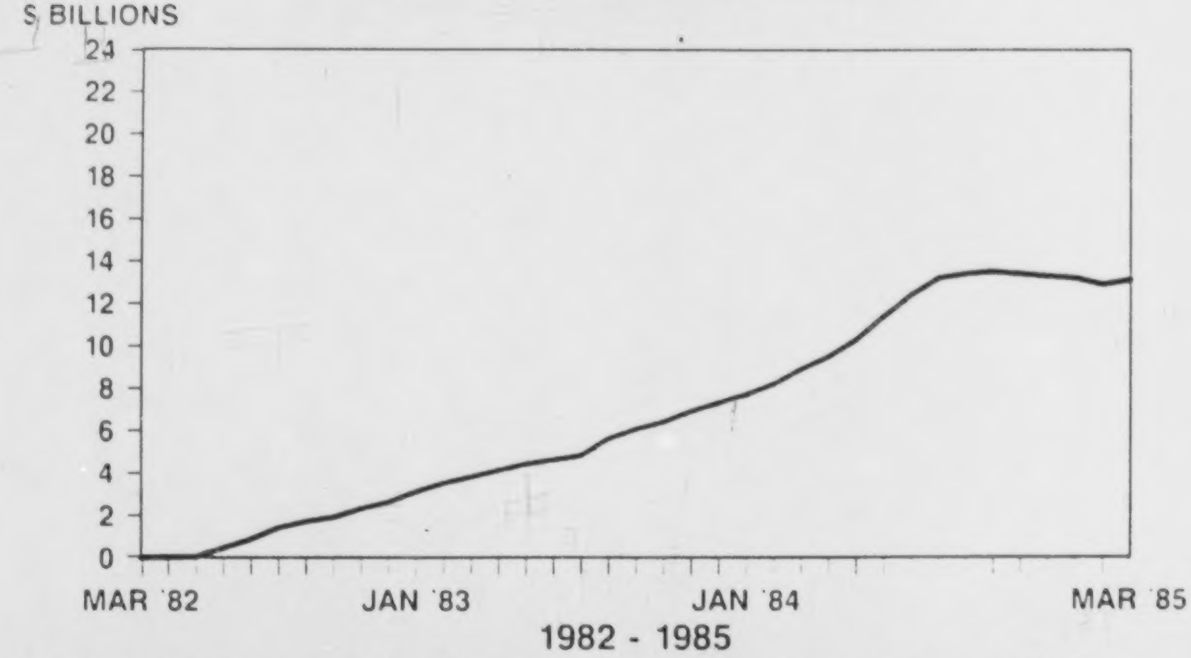
[1] FHLBB ACTUALS AND PROJECTIONS ARE FROM JANUARY 16, 1984 FHLBB NEWS RELEASE. EXTRAPOLATION IS "BASED ON AVERAGE GROWTH RATE SINCE JUNE 1982."

[2] MERRILL LYNCH ESTIMATES AND PROJECTIONS OF INDIVIDUAL INSURED BROKERED DEPOSITS AT THRIFTS REFLECTING THREE STAGES OF DIDC DEREGULATION: MAY 1982 (3½ YEARS AND LONGER), APRIL 1983 (2½ YEARS AND LONGER), OCTOBER 1983 (MOST REMAINING TIME DEPOSITS).

EXHIBIT VII

MERRILL LYNCH INSURED CD OUTSTANDINGS

TOTAL INSURED CDs*



* MERRILL LYNCH INSURED RETAIL CD PROGRAM: $1.000-$90.000 DENOMINATIONS. MATURITIES OF 3 MONTHS TO 12 YEARS. SOLD THROUGH RETAIL ACCOUNT EXECUTIVES LARGELY TO INDIVIDUALS.

EXHIBIT VIII

CATES CONSULTING ANALYSTS, INC.

"ANALYSIS OF 1984 COMMERCIAL BANK AND SAVINGS & LOANS FAILURES"
Executive Summary

"RELATIONSHIP BETWEEN BROKERED DEPOSITS AND FAILURES OF COMMERCIAL BANKS AND SAVINGS AND LOANS: 1982 - 1985"
Executive Summary and Tables

ANALYSIS OF 1984 COMMERCIAL BANK AND SAVINGS AND LOAN FAILURES

EXECUTIVE SUMMARY

Our purpose herein is to analyze the failures of both commercial banks and savings and loans in 1984 in order to identify the reasons for such failures. We will also explore the relationship, if any, between brokered deposits and the failure of financial institutions.

We analyzed five critical risk categories in order to determine whether they contributed significantly to commercial bank and savings and loan failures in 1984: liquidity risk, asset quality risk, interest-rate risk, overhead risk, and capital risk. We used selected financial ratios as indicators of the extent to which each of the five risks was present in failed institutions.

Commercial Banks. The evidence clearly shows that asset quality risk was responsible for bank failures in 1984. There were several critical indicators of extremely poor asset quality that were present in most failed banks to a much greater extent than in other banks: high and increasing net charge-offs; levels of non-performing loans serveral times peer group norms; and a loan yield substantially higher than that of other banks, which invariably points to higher risk levels in the loan portfolio. While other risk factors were present to varying degrees in banks that failed, none were nearly as predominant as the characteristics pointing to poor asset quality.

We also assessed whether brokered deposits were a significant factor in 1984 commercial bank failures. Approximately 63% of the 60 banks examined had no brokered deposits and in nine others such deposits comprised less than 7% of total deposits. The number of failed banks with a significant amount of brokered deposits, approximately 23%, was not sufficient to support the contention that brokered deposits caused bank failures. The relatively high dependence on purchased money of banks that failed in 1984, compared with that of similar sized banks, indicates that to focus on brokered deposits is misleading and incorrect. Brokered deposits is only one type of purchased money, and since banks that failed used alternative sources extensively, the reduction or elimination of brokered deposits would have little or no effect on bank failures. Finally, even in failed banks that made substantial use of brokered deposits, the usage of other sources of purchased funds was very high, and on average, accounted for over 60% of total purchased funding in those banks. We conclude that there is little, if any, evidence to support a causal relationship between brokered deposits and bank failures.

Savings and Loans. The data clearly show that an outsize degree of interest-rate risk was the cause of savings and loan failures during the 1981-1984 period. The net interest margin, the key barometer of interest-rate risk for savings and loans, worsened steadily through 1982 for all savings and loans. In failed S&Ls, the margin was considerably lower and the downward trend was more pronounced, suggesting that their risk exposure to adverse rate movements was even higher. The other risk factors were not present in failed savings and loans to a significant extent.

We also examined specifically the relationship between brokered deposits and 1984 savings and loans failures. Brokered deposits were either not present or only present in insignificant amounts in the predominant majority (75%) of 1984 S&Ls. The data also indicate that failed S&Ls used purchased money to a far greater extent than other comparably sized savings and loans.

Consequently, they had access to funding sources other than brokered deposits. The presence of large amounts of brokered deposits in a few institutions reflected management's choice to use brokered funds. It did not indicate a lack of alternative funding sources.

We also examined the extent to which failed savings and loans used Federal Home Loan Bank (FHLB) Advances. For failed S&Ls, FHLB Advances represented, on average, a surprisingly high 68% of total purchased funding and was present in amounts five times greater than in healthy savings and loans. If one were to argue that a specific type of liability causes savings and loan failures, and we certainly do not, the overwhelming evidence points to deposits provided by the FHLB System itself, not brokered deposits. In summary, the data clearly indicate that brokered deposits was not a significant factor in 1984 savings and loan failures.

CATES CONSULTING ANALYSTS, INC.

Relationship Between Brokered Deposits and Failures of Commercial Banks and Savings and Loans: 1982-1985

CATES CONSULTING ANALYSTS, INC.

Relationship Between Brokered Deposits and Failures of Commercial Banks and Savings and Loans: 1982-1985

Executive Summary

Our purpose herein is to explore the relationship, if any, between brokered deposits and the failure of financial institutions. We analyzed banks and savings and loans separately. Approximately 66% of the 206 banks that failed during the period examined had no brokered deposits and in 22 others such deposits comprised less than 7% of total deposits. The number of failed banks with a significant amount of brokered deposits, approximately 23%, was therefore, not sufficient to support the contention that brokered deposits caused bank failures. The relatively high dependence on purchased money of banks that failed during this period, compared with that of comparably sized banks, indicates that to focus on brokered deposits is misleading and incorrect. Banks that failed used alternative purchased funding sources extensively, and the reduction or elimination of brokered deposits would have hhad little or no effect on bank failures. Finally, even in failed banks that made substantial use of brokered deposits, the usage of other sources of purchased funds was very high, and on average, accounted for approximately 60% of total purchased funding in those banks. We conclude that there is little, if any, evidence to support a causal relationship between brokered deposits and commercial bank failures.

Brokered deposits were not present in the predominant majority (72.5%) of the 160 savings and loans that failed during the 1982-1985 period. In 24 other failures such deposits comprised less than 5% of total deposits. Therefore, 84.3% of failed savings and loans had little or no brokered deposits, hardly a record supporting an argument that brokered deposits caused savings and loan failures. The data also indicate that failed savings and loans used purchased money to a far greater extent than other comparably sized savings and loans. Furthermore, for those failed savings and loans that had brokered deposits, such brokered funding comprised, on average, only 7.8% of total purchased funding sources. These savings and loans obviously had considerable access to funding sources other than brokered deposits, and to restrict brokered funds would have had little impact on the ability of failed savings and loans to attract funding.

In summary, we conclude that the overwhelming evidence indicates that brokered deposits were either not present or only present in insignificant amounts in the substantial majority of financial institutions that failed in 1982-1985 and that brokered funds do not cause the failure of financial institutions.

CATES CONSULTING ANALYSTS, INC.

Brokered Deposits Data,
Commercial Banks and Savings & Loans
That Failed During Period From
January 1, 1982 to June 30, 1985

CATES CONSULTING ANALYSTS, INC.

Table 1: Incidence of Brokered Deposits,
Banks That Failed During Period from
January 1, 1982 to June 30, 1985

Total Assets (millions)	Number of Failures	Number With No Brokered Deposits	% With No Brokered Deposits
0- 10	45	37	82.2%
10- 20	51	35	68.6
20- 25	26	18	72.0
25- 40	37	26	70.3
40-100	25	12	48.0
100-300	17	7	41.2
300-500	3	0	00.0
500-1Billion	1	1	100.0
1-2Billion	1	0	00.0
Total	206	136	66.0%

Number with Brokered Deposits,
Classified by Percent of Total Deposits

	< 5%	5-10%	10-15%	15-20%	> 20%
0- 10	1	3	2	0	2
10- 20	3	1	2	3	7
20- 25	3	1	0	0	4
25- 40	5	0	1	1	4
40-100	4	2	2	0	5
100-300	1	2	0	0	7
300-500	0	0	1	0	2
500-1Billion	0	0	0	0	0
1-2Billion	0	0	1	0	0
Total	17	9	9	4	31

Table 2: Brokered Deposits and Total Purchased Funding Sources, Banks That Failed During Period From January 1, 1982 to June 30, 1985*

Total Assets (Millions)	Number of Failures	Brokered Deposits to Total Deposits	Purchased Funds to Earning Assets	Purchased Funds to Earning Assets: Peer **	Brokered Dep. to Earning Assets	Brokered Dep. to Purchased Funds
0- 10	45	0.00%	20.78%	6.44%	0.00%	0.00%
10- 20	50	0.00	15.42	7.49	0.00	0.00
20- 25	26	0.00	26.09	8.76	0.00	0.00
25- 40	37	0.00	18.64	9.29	0.00	0.00
40-100	24	1.06	32.75	9.34	1.39	2.84
100-300	16	5.26	43.08	11.10	4.00	7.54
300-500	3	26.37	61.30	25.45	25.01	40.80
500-1Billion	1	0.00	59.99	27.70	0.00	0.00
1-2Billion	1	12.67	60.02	37.42	4.85	8.08
Total	203***	0.00%	23.08%	-	0.00%	0.00%

* The data displayed represents the median ratio for each grouping of banks.

** The data displayed in this column represents the median ratio for all banks of comparable size in the nation.

***There were 208 commercial bank failures during the period. Data is not available for five banks that failed.

Table 3: Brokered Deposits and Total Purchased Funding Sources, Banks With Brokered Deposits That Failed During Period From January 1, 1982 to June 30, 1985*

Total Assets (Millions)	Number of Failures	Brokered Deposits to Total Deposits	Purchased Funds to Earning Assets	Purchased Funds to Earning Assets: Peer **	Brokered Dep. to Earning Assets	Brokered Dep. to Purchased Funds
0- 10	8	10.96%	30.08%	6.44%	12.64%	41.19%
10- 20	16	18.34	30.95	7.49	20.51	77.15
20- 25	8	15.46	43.14	8.76	18.42	33.42
25- 40	11	10.61	39.90	9.29	7.47	19.22
40-100	12	8.80	51.54	9.34	9.76	19.56
100-300	9	23.20	59.05	11.10	16.53	36.53
300-500	3	26.37	61.30	25.45	25.01	40.80
500-1Billion	0	-	-	27.70	-	-
1-2Billion	1	12.67	60.02	37.42	4.85	8.08
Total	68	14.93	39.16	-	15.89	40.85

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* The data displayed represents the median ratio for each grouping of banks.

** The data displayed in this column represents the median ratio for all banks of comparable size in the nation.

Table 4: Distribution Ranges, Brokered Deposits and Purchased Funding Sources, Banks That Failed During Period From January 1, 1982 to June 30, 1985

	Low	First Quartile	Median	Third Quartile	High
Brokered Deposits to Total Deposits	0.00%	0.00%	0.00%	5.09%	75.59%
Purchased Funds to Earning Assets	1.16	11.19	23.08	37.22	198.35
Brokered Deposits to Earning Assets	0.00	0.00	0.00	5.00	197.98
Brokered Deposits to Purchased Funds	0.00	0.00	0.00	18.49	5826.00

Table 5:. Distribution Ranges, Brokered Deposits and Purchased Funding Sources, Banks with Brokered Deposits That Failed During Period From January 1, 1982 to June 30, 1985

	Low	First Quartile	Median	Third Quartile	High
Brokered Deposits to Total Deposits	0.75	4.75	14.93	30.07	75.59
Purchased Funds to Earning Assets	4.48	26.01	39.16	50.36	80.31
Brokered Deposits to Earning Assets	0.75	4.85	15.89	31.65	197.98
Brokered Deposits to Purchased Funds	5.57	15.83	40.85	73.88	5826.00

Table 6: Incidence of Brokered Deposits,
S&Ls That Failed During Period from
January 1, 1982 to June 30, 1985

Total Assets (millions)	Number of Failures*	Number With No Brokered Deposits	% With No Brokered Deposits
0- 10	4	2	50.0%
10- 25	19	13	68.4
25- 50	34	29	85.3
50-100	26	20	76.9
100-250	33	22	66.7
250-500	19	13	68.4
500-1Billion	16	9	58.8
1B+	9	8	88.9
Total	160	116	72.5%

Number with Brokered Deposits,
Classified by Percent of Total Deposits

	5%	5-10%	10-15%	15-20%	20%
0- 10	0	1	0	0	1
10- 25	2	2	1	0	1
25- 50	2	0	0	0	3
50-100	3	2	0	1	0
100-250	6	1	0	2	2
250-500	5	0	0	0	1
500-1Billion	5	0	1	0	1
1B+	1	0	0	0	0
Total	24	6	2	3	9

* Savings and Loan Failures include all FSLIC assisted acquisitions and mergers and FSLIC insurance of accounts cases. Not included are Savings and Loans merged due to supervisory action by the FHLBB.

Table 7: Brokered Deposits and Total Purchased Funding Sources, S&Ls That Failed During Period From January 1, 1982 to June 30, 1985*

Total Assets (Millions)	Number of Failures	Brokered Deposits to Total Deposits	Purchased Funds to Earning Assets	Purchased Funds to Earning Assets: Peer **	Brokered Dep. to Earning Assets	Brokered Dep. to Purchased Funds
0- 10	4	2.52%	41.76%	3.12%	0.90%	6.23%
10- 25	19	0.00	15.01	2.96	0.00	0.00
25- 50	34	0.00	16.33	3.41	0.00	0.00
50-100	26	0.00	27.35	5.42	0.00	0.00
100-250	33	0.00	33.69	8.79	0.00	0.00
250-500	19	0.00	34.57	13.60	0.00	0.00
500-1Billion	16	0.00	24.07	17.86	0.00	0.00
1B+	9	0.00	25.43	22.53	0.00	0.00
Total	160	0.00%	26.25%	-	0.00%	0.00%

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* The data displayed represents the median ratio for each grouping of banks.

** The data displayed in this column represents the median ratio for all banks of comparable size in the nation.

Table 8: Brokered Deposits and Total Purchased Funding Sources, S&Ls With Brokered Deposits That Failed During Period From January 1, 1982 to June 30, 1985*

Total Assets (Millions)	Number of Failures	Brokered Deposits to Total Deposits	Purchased Funds to Earning Assets	Purchased Funds to Earning Assets: Peer **	Brokered Dep. to Earning Assets	Brokered Dep. to Purchased Funds
0- 10	2	41.27%	41.76%	3.12%	107.97%	55.28%
10- 25	6	9.29	44.07	2.96	9.62	21.85
25- 50	5	34.69	32.30	3.41	16.51	51.11
50-100	6	3.75	36.46	5.42	1.48	4.63
100-250	11	3.08	39.99	8.79	1.30	3.18
250-500	6	2.09	50.94	13.60	0.06	0.11
500-1Billion	7	1.54	34.34	17.86	0.75	2.85
1B+	1	1.08	56.27	22.53	0.19	0.34
Total	44	4.36	41.63	-	2.21	7.81%

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* The data displayed represents the median ratio for each grouping of banks.

** The data displayed in this column represents the median ratio for all banks of comparable size in the nation.

Table 9: Distribution Ranges, Brokered Deposits and Purchased Funding Sources, S&Ls That Failed During Period From January 1, 1982 to June 30, 1985

	Low	First Quartile	Median	Third Quartile	High
Brokered Deposits to Total Deposits	0.00%	0.00%	0.00%	0.12%	79.23%
Purchased Funds to Earning Assets	0.00	14.22	26.25	41.18	218.27
Brokered Deposits to Earning Assets	0.00	0.00	0.00	0.05	214.13
Brokered Deposits to Purchased Funds	0.00	0.00	0.00	0.22	98.1

Table 10: Distribution Ranges, Brokered Deposits and Purchased Funding Sources, S&Ls with Brokered Deposits That Failed During Period From January 1, 1982 to June 30, 1985

	Low	First Quartile	Median	Third Quartile	High
Brokered Deposits to Total Deposits	0.06%	0.78%	4.36%	18.70%	79.23%
Purchased Funds to Earning Assets	7.68	28.25	41.63	59.44	218.27
Brokered Deposits to Earning Assets	0.05	0.60	2.21	16.51	214.13
Brokered Deposits to Purchased Funds	0.15	1.86	7.81	48.73	98.10

Chairman HUBBARD. Am I correct that Mr. Thomas is the one who will give the testimony and then also Mr. Reibman will be available for questions?

Mr. THOMAS. That is correct.

Chairman HUBBARD. Ray Thomas is first vice president and assistant general counsel with Dean Witter Reynolds of New York.

Mr. THOMAS. We have submitted the full statement and I would like to summarize my comments today.

Chairman HUBBARD. Your full statement will be entered into the record.

STATEMENT OF RAYMOND V. THOMAS, FIRST VICE PRESIDENT AND ASSISTANT GENERAL COUNSEL, DEAN WITTER REYNOLDS OF NEW YORK; ACCOMPANIED BY DICK REIBMAN, MANAGING DIRECTOR

Mr. THOMAS. Thank you for the invitation to appear before the subcommittee today. Joining me today is Dick Reibman, managing director of Dean Witter Reynolds, Inc., and director of its brokered deposits program.

Sears, Roebuck & Co. is concerned with the issue of brokered deposits as both a recipient of brokered deposits through its savings and loan association—Sears Savings Bank—and as a broker of such deposits through its securities brokerage affilate, Dean Witter Reynolds.

Sears recognizes that, underlying market forces as well as regulatory and legislative actions are profoundly changing the financial services industry. Concerns have arisen regarding the continuing soundness of the Federal deposit insurance system due to the increasing number of financial institution failures.

Failures occur because institutions are not able to deal with the changed economic and competitive environments in which they must operate. Additionally, failures resulting from mismanagement, fraud, and financial abuse, will continue to occur.

Recently, regulators of the Federal deposit insurance systems have cited another cause of these failures—the use of brokered funds. Sears recognizes that the potential misuse of brokered funds is a cause for concern on the part of these regulators, but we strongly disagree with the regulators' assertions that there is a cause and effect relationship between the use of brokered funds and a depository institution failure.

To prevent possible abuses of the deposit insurance systems—specifically with regard to brokered deposits—care must be taken to ensure that any corrective regulatory or legislative solution is carefully tailored to deal with the abuses without stifling healthy, well-managed depository institutions or the benefits of innovative changes in the marketing of financial services.

Today I would like to focus my comments on the status of the use of brokered deposits, the problems associated with alternative legislative and regulatory proposals for dealing with brokered deposits, and the degree to which these alternative proposals are consistent with Federal policy regarding deposit insurance.

First, it is important to define what is meant by the term "brokered funds." We believe that an accurate definition and analysis of the brokered funds market has been presented by Merrill Lynch here today and is contained in their written submission.

Merrill Lynch has identified three basic markets: institutional uninsured brokered funds, institutional insured brokered funds, and individual insured brokered funds. Dean Witter acts as deposit broker primarily for individual insured funds and, to some extent, for institutional uninsured funds.

Despite the clear differences between these markets, the tendency of the regulators has been to lump them together statistically when making statements about the size of the brokered funds market and hence the potential magnitude of the problem they perceive. This is unfortunate, and also it is potentially misleading, because the institutional uninsured brokered funds market is the largest market and it does not pose a threat to the soundness of the Federal insurance funds. We think the facts demonstrate that the institutional insured brokered funds market, by far the smallest of the three markets, is the market more prone to abuse.

The proposed regulatory solutions we have seen tend to treat the two insured markets together as a target to be stripped of insurance eligibility. This is despite the important benefits insured brokered deposits—in particular in the individual market—are currently providing. These benefits include benefits to depository institutions, to consumers and to the national economy.

Depository institutions benefit from the use of brokered funds in a number of ways.

Funds raised through brokers are generally less expensive than funds obtained through traditional branch networks because these networks require a large investment in fixed assets and personnel. In addition, brokered deposits can provide access to longer term funds which are necessary to the balancing of assets with liabilities to avoid maturity mismatches. Such mismatches have been the principal cause of the recent losses incurred by S&L's.

The insured deposit brokering mechanism also provides institutions—particularly smaller ones and new entrants—access to money markets outside of their local geographic base, thereby enhancing competition.

In addition, brokered funds permit well managed institutions to meet market demands which is particularly important in today's competitive marketplace. It should be noted that those institutions which have failed, and have had a high percentage of brokered funds, have failed not because of the way the funds were gathered, but rather because of the way the institutions were managed and how they invested their funds.

Consumers also benefit from the availability of insured brokered deposits. Brokered deposits provide consumers with access to high-quality, fixed-income instruments having competitive market rates, convenience, and liquidity, all without sacrificing safety. Today, brokered deposits give small depositors the same advantages formerly available only to depositors investing $100,000 or more.

In addition, such deposits give all consumers more investment options by not restricting them to a local market or to a particular investment vehicle. Through the use of a broker, consumers can seek out higher yields and greater safety for investments than might be available locally.

Finally, the economy as a whole benefits from brokered funds in that they facilitate the flow of funds from capital rich, investment poor areas, to capital poor areas with high growth potential. This tends to stabilize money costs nationwide.

Additionally, more loans for housing are available when thrifts are able to compete with the money market mutual funds for consumers' deposits.

In summary, brokered deposits currently provide the Nation's depository institutions and consumers with a variety of sound financial options. Deposit brokerage enhances a depositor's options regarding where and how to deposit funds, deposit brokerage enhances funding options available to depository institutions, and deposit brokerage increases the efficiency of the financial markets.

All of these advantages are consistent with, and clearly do not abuse, our Federal deposit insurance system.

Federal deposit insurance was intended to assure depositors that they could safely invest their money in the country's financial institutions. The fact that some depositors prefer to go to a money broker to place deposits rather than go directly to a branch of a local financial institution is not a misuse of the deposit insurance system.

The major criticism of money brokers centers around the charge that market discipline has eroded under the current money broker system.

In the case of an SEC registered broker dealer, such as Dean Witter, this is simply not accurate Dean Witter conducts a comprehensive analysis of the financial soundness of the depository institutions for which it brokers deposits.

The analysis of potential certificate of deposit issuers is identical to that Dean Witter performs when it extends credit to another institution. This credit analysis includes a thorough evaluation of information contained in regulatory monthly call reports, an appraisal of management expertise, capitalization requirements, quality and configuration of portfolio assets, and so forth.

While this credit analysis cannot provide absolute assurance of continuing financial soundness, it does sort out potential problem institutions for which Dean Witter will not broker deposits.

Dean Witter conducts this credit analysis primarily for two reasons. First, Dean Witter is concerned about its continuing relationship with the client who purchases a brokered certificate of deposit through Dean Witter.

In the event of a depository institution's failure, Dean Witter would lose the confidence—and the future business—of that client. Therefore, the credit analysis is of the utmost importance to the long-term success of Dean Witter brokerage business.

The second reason for a rigorous credit analysis is that Dean Witter makes a secondary market in the certificates of deposit (CD's) it brokers. For example, if a 5-year CD is sold to an individual who, within 2 years, wishes to retrieve those savings, Dean Witter would repurchase the CD and resell it to a different individual wishing to purchase a 3-year CD.

At any one time, some repurchased CD's might not be immediately resold and therefore would be held in inventory. Since brokers holding such CD's in inventory are only covered up to

$100,000 in deposit insurance, a strong incentive exists to broker deposits only for institutions which are financially stable. This assures the broker that losses will not be suffered on the CD's held in inventory.

Because of these reasons, Dean Witter believes that market discipline as to SEC registered broker-dealers is currently functioning properly.

Sears recognizes, Mr. Chairman, that there are situations in which a depository institution's rapid growth, which it chooses to fund through the use of brokered deposits may, depending on the facts and circumstances, be a source of regulatory concern. Sears therefore supports legislative proposals which address the concerns of regulators on the potential misuse of brokered funds by unsound institutions without eliminating constructive uses of such funds.

Several legislative proposals—specifically H.R. 1680 and H.R. 1833—have been introduced in the House which, while not directly limiting brokered deposits, would give the Federal deposit insurance agencies broad new powers to promulgate rules which could substantially curtail or eliminate brokered deposits.

Sears opposes measures which have the effect of eliminating or significantly curtailing insured deposit brokerage and the benefits deposit brokerage can provide to depository institutions, the national economy and the consumer.

Recently, the Federal Home Loan Bank Board issued a proposed revision to its recordkeeping regulations [50 Fed. Reg. 19185 (May 7, 1985)] which, while offering clarification of existing regulations, would require broker-dealers to provide an issuing institution with names and addresses of customers for which it brokers deposits. The regulation is duplicative in nature and would require depository institutions and deposit brokers to restructure current administrative procedures which are highly effective and economical from the viewpoint of both the broker and the depository institution.

A result of this regulation could be to eliminate insured brokered deposits. The most likely practical effect of the proposed regulation will be to significantly increase the expense of acquiring brokered deposits, while overlooking the potential problems associated with the misuse of brokered funds by weak institutions.

Sears endorses the approach taken by Congressmen Garcia, Schumer, and Barnard in H.R. 107. The proposal addresses the concerns of regulators on the potential misuse of brokered funds while providing for constructive uses of such funds.

To begin with, the bill limits an institution's ability to accept short-term brokered deposits to 15 percent of its total deposits. We believe that provision alone would reduce most misuses of brokered deposits.

H.R. 107 does nothing to hamper the long-term brokered funds market which is so vital to the asset and liability restructuring efforts of the thrift industry. Only by proper restructuring efforts will thrifts regain viability as an industry.

H.R. 107 is consistent with Federal policy regarding deposit insurance. In fact, Sears believes H.R. 107 will actually help reduce potential drains on insurance funds maintained by the FDIC and FSLIC. First, brokered deposits could be used by depository institutions as a vehicle to become stronger by being better able to meet funding needs.

Second, by limiting the amount of short-term brokered funds or so-called hot money, which are most prone to be used by troubled depository institutions, H.R. 107 reduces the potential of losses to the deposit insurance funds.

Passage of H.R. 107 should be accompanied by renewed efforts by bank regulators to enforce regulations designed to make sure that insured institutions conduct their business in a safe and sound manner.

In summary, Sears believes that H.R. 107 if it is passed and rigorously enforced, would go a long way to alleviate the possibility that mismanaged depository institutions could put a burden on the Federal Deposit Insurance System through the misuse of brokered deposits.

Any other approaches, particularly those aimed at eliminating or severely curtailing deposit insurance for brokered funds, will harm rathar than help depository institutions, the economy, and consumers.

We commend you, Mr. Chairman, and members of the subcommittee for conducting this important hearing on the issue of brokered deposits.

On behalf of Sears, Roebuck & Co., we particulary want to thank Congressmen Garcia, Schumer, and Barnard for their very positive and constructive contribution to resolving the concerns that surround the issue of the deposit insurance system with regard to the uses of brokered funds.

Thank you for your attention.

Dick Reibman and I will be pleased to do our best to answer your questions.

[The following prepared statement of Mr. Thomas on behalf of Dean Witter Reynolds, Inc., and Sears, Roebuck & Co. and a letter correcting inaccuracies in Chairman Isaac's testimony regarding position of the failed insured institution, Girod Trust Co. of San Juan, PR, follow:]

STATEMENT OF RAYMOND THOMAS

FIRST VICE PRESIDENT - ASSISTANT GENERAL COUNSEL
DEAN WITTER REYNOLDS, INC.
SEARS, ROEBUCK AND CO.

BEFORE THE
SUBCOMMITTEE ON GENERAL OVERSIGHT
AND INVESTGATIONS
OF THE
COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

JULY 16, 1985

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE.

THANK YOU FOR THE INVITATION TO APPEAR BEFORE THE SUBCOMMITTEE TODAY. JOINING ME TODAY IS DICK REIBMAN, MANAGING DIRECTOR OF DEAN WITTER REYNOLDS INC. AND "DIRECTOR" OF ITS BROKERED DEPOSITS PROGRAM.

SEARS, ROEBUCK AND CO. IS CONCERNED WITH THE ISSUE OF BROKERED DEPOSITS AS BOTH A RECIPIENT OF BROKERED DEPOSITS THROUGH ITS SAVINGS AND LOAN ASSOCIATION - SEARS SAVINGS BANK - AND AS A BROKER OF SUCH DEPOSITS THROUGH ITS SECURITIES BROKERAGE AFFILIATE, DEAN WITTER REYNOLDS.

SEARS RECOGNIZES THAT, UNDERLYING MARKET FORCES AS WELL AS REGULATORY AND LEGISLATIVE ACTIONS ARE PROFOUNDLY CHANGING THE FINANCIAL SERVICES INDUSTRY. CONCERNS HAVE ARISEN REGARDING THE CONTINUING SOUNDNESS OF THE FEDERAL DEPOSIT INSURANCE SYSTEM DUE TO THE INCREASING NUMBER OF FINANCIAL INSTITUTION FAILURES. FAILURES OCCUR BECAUSE INSTITUTIONS ARE NOT ABLE TO DEAL WITH THE CHANGED ECONOMIC AND COMPETITIVE ENVIRONMENTS IN WHICH THEY MUST OPERATE. THE HIGH RATE OF FAILURES IN THE SAVINGS AND LOAN INDUSTRY IN RECENT YEARS IS A PRIME EXAMPLE. PRUDENT BANKS WITH LOANS TO FAILING FARMERS AND WITH LOANS IN AREAS HIT HARD BY ADVERSE ECONOMIC FACTORS ARE OTHER EXAMPLES. FINALLY, FAILURES RESULTING FROM MISMANAGEMENT, FRAUD, AND FINANCIAL ABUSE, WILL CONTINUE TO OCCUR.

RECENTLY, REGULATORS OF THE FEDERAL DEPOSIT INSURANCE SYSTEMS HAVE CITED ANOTHER CAUSE OF THESE FAILURES -- THE USE OF BROKERED FUNDS. SEARS RECOGNIZES THAT THE POTENTIAL MISUSE OF BROKERED FUNDS IS A CAUSE FOR CONCERN ON THE PART OF THESE REGULATORS, BUT WE STRONGLY DISAGREE WITH THE REGULATORS' ASSERTIONS THAT THERE IS A CAUSE AND EFFECT RELATIONSHIP BETWEEN THE USE OF BROKERED FUNDS AND A DEPOSITORY INSTITUTION FAILURE. TO PREVENT POSSIBLE ABUSES OF THE DEPOSIT INSURANCE SYSTEMS -- SPECIFICALLY WITH REGARD TO BROKERED DEPOSITS -- CARE MUST BE TAKEN TO ENSURE THAT ANY CORRECTIVE REGULATORY OR LEGISLATIVE SOLUTION IS CAREFULLY TAILORED TO DEAL WITH THE ABUSES WITHOUT STIFLING HEALTHY, WELL-MANAGED DEPOSITORY INSTITUTIONS OR THE BENEFITS OF INNOVATIVE CHANGES IN THE MARKETING OF FINANCIAL SERVICES.

TODAY I WOULD LIKE TO FOCUS MY COMMENTS ON THE STATUS OF THE USE OF BROKERED DEPOSITS, THE PROBLEMS ASSOCIATED WITH ALTERNATIVE LEGISLATIVE AND REGULATORY PROPOSALS FOR DEALING WITH BROKERED FUNDS, AND THE DEGREE TO WHICH THESE ALTERNATIVE PROPOSALS ARE CONSISTENT WITH FEDERAL POLICY REGARDING DEPOSIT INSURANCE.

STATUS OF THE USE OF BROKERED DEPOSITS

FIRST, IT IS IMPORTANT TO DEFINE WHAT IS MEANT BY THE TERM "BROKERED FUNDS." WE BELIEVE THAT AN ACCURATE DEFINITION AND ANALYSIS OF THE BROKERED FUNDS MARKET HAS BEEN PRESENTED BY MERRILL LYNCH. MERRILL LYNCH HAS IDENTIFIED THREE BASIC MARKETS: INSTITUTIONAL UNINSURED BROKERED FUNDS, INSTITUTIONAL INSURED BROKERED FUNDS AND INDIVIDUAL INSURED BROKERED FUNDS.

DESPITE THE CLEAR DIFFERENCES BETWEEN THESE MARKETS, THE TENDENCY OF THE REGULATORS HAS BEEN TO LUMP THEM TOGETHER STATISTICALLY WHEN MAKING STATEMENTS ABOUT THE SIZE OF THE BROKERED FUNDS MARKET AND HENCE THE POTENTIAL MAGNITUDE OF THE PROBLEM THEY PERCEIVE. THIS IS UNFORTUNATE, AND ALSO POTENTIALLY MISLEADING, BECAUSE THE INSTITUTIONAL UNINSURED BROKERED FUNDS MARKET IS THE LARGEST MARKET AND IT DOES NOT POSE A THREAT TO THE SOUNDNESS OF THE FEDERAL INSURANCE FUNDS. WE THINK THE FACTS DEMONSTRATE THAT THE INSTITUTIONAL INSURED BROKERED FUNDS MARKET, BY FAR THE SMALLEST OF THE THREE MARKETS, IS THE MARKET MOST PRONE TO ABUSE.

THE PROPOSED REGULATORY SOLUTIONS WE HAVE SEEN TEND TO TREAT THE TWO INSURED MARKETS TOGETHER AS A TARGET TO BE STRIPPED OF INSURANCE ELIGIBILITY. THIS IS DESPITE THE IMPORTANT BENEFITS INSURED BROKERED DEPOSITS -- IN PARTICULAR IN THE INDIVIDUAL MARKET -- ARE CURRENTLY PROVIDING. THESE BENEFITS INCLUDE BENEFITS TO DEPOSITORY INSTITUTIONS, TO CONSUMERS AND TO THE NATIONAL ECONOMY.

INDIVIDUAL DEPOSITORY INSTITUTIONS BENEFIT FROM THE USE OF BROKERED FUNDS IN A NUMBER OF WAYS.

FUNDS RAISED THROUGH BROKERS ARE GENERALLY LESS EXPENSIVE THAN FUNDS OBTAINED THROUGH TRADITIONAL BRANCH NETWORKS BECAUSE THESE NETWORKS REQUIRE A LARGE INVESTMENT IN FIXED ASSETS AND PERSONNEL OVERHEAD. IN ADDITION, BROKERED DEPOSITS CAN PROVIDE ACCESS TO LONGER TERM FUNDS WHICH ARE SO NECESSARY TO THE PROCESS OF BALANCING ASSETS WITH LIABILITIES TO AVOID MATURITY MISMATCHES. SUCH MISMATCHES HAVE BEEN THE PRINCIPAL CAUSE OF THE RECENT LOSSES INCURRED BY S & LS.

SEARS SAVINGS BANK RELIES ON BOTH INSURED AND UNINSURED BROKERED DEPOSITS IN ITS FUNDING STRATEGY. AS OF THE END OF MAY, BROKERED UNINSURED ACCOUNTS REPRESENT SOME 27% OF SEARS SAVINGS BANK'S TOTAL DEPOSIT BASE. INSURED BROKERED DEPOSITS ON THE OTHER HAND REPRESENT ALMOST 17% OF SEARS SAVINGS BANK'S TOTAL DEPOSIT BASE. THESE FUNDS REPRESENT A NEW AND EXPANDED CUSTOMER BASE, A SIGNIFICANT SOURCE OF DEPOSIT GROWTH, AND THEY HELP THE SAVINGS BANK ACHIEVE IMPORTANT ASSET AND LIABILITY RESTRUCTURING GOALS.

THE INSURED DEPOSIT BROKERING MECHANISM ALSO PROVIDES INSTITUTIONS -- PARTICULARLY SMALLER ONES AND NEW ENTRANTS -- ACCESS TO MONEY MARKETS OUTSIDE OF THEIR LOCAL GEOGRAPHIC BASE, THEREBY ENHANCING COMPETITION.

IN ADDITION, BROKERED FUNDS PERMIT WELL MANAGED INSTITUTIONS TO MEET MARKET DEMANDS -- PARTICULARLY IN TODAY'S COMPETITIVE MARKETPLACE. IT IS IMPORTANT TO NOTE THAT THOSE INSTITUTIONS WHICH HAVE FAILED, AND HAVE HAD A HIGH PERCENTAGE OF BROKERED FUNDS, HAVE FAILED NOT BECAUSE OF THE WAY THE FUNDS WERE GATHERED, BUT RATHER BECAUSE OF THE WAY THE INSTITUTIONS WERE MANAGED AND HOW THEY INVESTED THESE FUNDS.

CONSUMERS ALSO BENEFIT FROM THE AVAILABILITY OF INSURED BROKERED DEPOSITS. BROKERED DEPOSITS PROVIDE CONSUMERS WITH ACCESS TO HIGH QUALITY, FIXED INCOME INSTRUMENTS HAVING COMPETITIVE MARKET RATES, CONVENIENCE AND LIQUIDITY, ALL WITHOUT SACRIFICING SAFETY. TODAY, BROKERED DEPOSITS GIVE THE SMALL DEPOSITOR THE SAME ADVANTAGES FORMERLY AVAILABLE ONLY TO DEPOSITORS INVESTING $100,000 OR MORE.

IN ADDITION, SUCH DEPOSITS GIVE ALL CONSUMERS MORE INVESTMENT OPTIONS BY NOT RESTRICTING THEM TO A LOCAL MARKET OR TO A PARTICULAR INVESTMENT VEHICLE. THROUGH THE USE OF A BROKER, CONSUMERS CAN SEEK OUT HIGHER YIELDS AND GREATER SAFETY FOR INVESTMENTS THAN MIGHT BE AVAILABLE LOCALLY.

FINALLY, THE ECONOMY AS A WHOLE BENEFITS FROM BROKERED FUNDS IN THAT THEY FACILITATE THE FLOW OF FUNDS FROM CAPITAL RICH, INVESTMENT POOR AREAS TO CAPITAL POOR AREAS WITH HIGH GROWTH POTENTIAL. THIS TENDS TO STABILIZE MONEY COSTS NATIONWIDE. ADDITIONALLY, MORE LOANS FOR HOUSING ARE AVAILABLE WHEN THRIFTS ARE ABLE TO COMPETE WITH THE MONEY MARKET MUTUAL FUNDS FOR CONSUMERS' DEPOSITS.

IN SUMMARY, BROKERED DEPOSITS CURRENTLY PROVIDE THE NATION'S DEPOSITORY INSTITUTIONS AND CONSUMERS WITH A VARIETY OF SOUND FINANCIAL OPTIONS. DEPOSIT BROKERAGE ENHANCES A DEPOSITOR'S OPTIONS REGARDING WHERE AND HOW TO DEPOSIT FUNDS, DEPOSIT BROKERAGE ENHANCES FUNDING OPTIONS AVAILABLE TO DEPOSITORY INSTITUTIONS, AND DEPOSIT BROKERAGE INCREASES THE EFFICIENCY OF THE FINANCIAL MARKETS. ALL OF THESE ADVANTAGES ARE CONSISTENT WITH, AND CLEARLY DO NOT ABUSE, OUR FEDERAL DEPOSIT INSURANCE SYSTEM.

FEDERAL DEPOSIT INSURANCE WAS INTENDED TO ASSURE DEPOSITORS THAT THEY COULD SAFELY INVEST THEIR MONEY IN THE COUNTRY'S FINANCIAL INSTITUTIONS. THE FACT THAT SOME DEPOSITORS PREFER TO GO TO A MONEY BROKER TO PLACE DEPOSITS RATHER THAN GO DIRECTLY TO A BRANCH OF A LOCAL FINANCIAL INSTITUTION IS NOT A MISUSE OF THE DEPOSIT INSURANCE SYSTEM.

THE MAJOR CRITICISM OF MONEY BROKERS CENTERS AROUND THE CHARGE THAT MARKET DISCIPLINE HAS ERODED UNDER THE CURRENT MONEY BROKER SYSTEM.

In the case of an SEC registered broker dealer, such as Dean Witter, this simply is not accurate. Dean Witter conducts a comprehensive analysis of the financial soundness of the depository institutions for which it brokers deposits. The analysis of potential certificate of deposit issuers is identical to that Dean Witter performs when it extends credit to another institution. This credit analysis includes a thorough evaluation of information contained in regulatory monthly call reports, an appraisal of management expertise, capitalization requirements, quality and configuration of portfolio assets and so forth. While this credit analysis can not provide absolute assurance of continuing financial soundness, it does sort out potential problem institutions for which Dean Witter will not broker deposits.

Dean Witter conducts this credit analysis primarily for two reasons. First, Dean Witter is concerned about its continuing relationship with the client who purchases a brokered certificate of deposit through Dean Witter. In the event of a depository institution's failure, Dean Witter would lose the confidence -- and the future business -- of that client. Therefore, the credit analysis is of the utmost importance to the long-term success of Dean Witter brokerage business.

The second reason for a rigorous credit analysis is that Dean Witter makes a secondary market in the certificates of deposit ("CDs") it brokers. For example, if a five year CD is sold to an individual who, within two years, wishes to retrieve those savings, Dean Witter would repurchase the CD and resell it to a different individual wishing to purchase a three year CD with that particular rate of interest.

AT ANY ONE TIME, SOME REPURCHASED CDS MIGHT NOT BE IMMEDIATELY RESOLD AND THEREFORE WOULD BE HELD IN INVENTORY. SINCE BROKERS HOLDING SUCH CDS IN INVENTORY ARE ONLY COVERED UP TO $100,000 IN DEPOSIT INSURANCE, A STRONG INCENTIVE EXISTS TO BROKER DEPOSITS ONLY FOR INSTITUTIONS WHICH ARE FINANCIALLY STABLE. THIS ASSURES THE BROKER THAT LOSSES WILL NOT BE SUFFERED ON THE CDS HELD IN INVENTORY.

BECAUSE OF THE TWO PREVIOUSLY DISCUSSED REASONS, DEAN WITTER BELIEVES THAT MARKET DISCIPLINE AS TO SEC REGISTERED BROKER-DEALERS IS CURRENTLY FUNCTIONING.

ALTERNATIVE LEGISLATIVE AND REGULATORY PROPOSALS

SEARS RECOGNIZES, MR. CHAIRMAN, THAT THERE ARE SITUATIONS IN WHICH A DEPOSITORY INSTITUTION'S RAPID GROWTH, WHICH IT CHOOSES TO FUND THROUGH THE USE OF BROKERED DEPOSITS MAY, DEPENDING ON THE FACTS AND CIRCUMSTANCES, BE A SOURCE OF REGULATORY CONCERN. SEARS THEREFORE SUPPORTS LEGISLATIVE PROPOSALS WHICH ADDRESS THE CONCERNS OF REGULATORS ON THE POTENTIAL MISUSE OF BROKERED FUNDS BY UNSOUND INSTITUTIONS WITHOUT ELIMINATING CONSTRUCTIVE USES OF SUCH FUNDS.

SEVERAL LEGISLATIVE PROPOSALS -- SPECIFICALLY H.R. 1680 AND H.R. 1833 -- HAVE BEEN INTRODUCED IN THE HOUSE WHICH, WHILE NOT DIRECTLY LIMITING BROKERED DEPOSITS, WOULD GIVE THE FEDERAL DEPOSIT INSURANCE AGENCIES BROAD NEW POWERS TO PROMULGATE RULES WHICH COULD SUBSTANTIALLY CURTAIL OR ELIMINATE BROKERED DEPOSITS.

SEARS OPPOSES MEASURES WHICH HAVE THE EFFECT OF ELIMINATING OR SIGNIFICANTLY CURTAILING INSURED DEPOSIT BROKERAGE AND THE BENEFITS DEPOSIT BROKERAGE CAN PROVIDE TO DEPOSITORY INSTITUTIONS, THE NATIONAL ECONOMY AND THE CONSUMER.

RECENTLY, THE FHLBB ISSUED A PROPOSED REVISION TO ITS RECORD-KEEPING REQUIREMENTS* WHICH, WHILE OFFERING CLARIFICATION OF EXISTING REGULATIONS, WOULD REQUIRE BROKER-DEALERS TO PROVIDE AN ISSUING INSTITUTION WITH NAMES AND ADDRESSES OF CUSTOMERS FOR WHICH IT BROKERS DEPOSITS. THE REGULATION IS DUPLICATIVE IN NATURE AND WOULD REQUIRE DEPOSITORY INSTITUTIONS AND DEPOSIT BROKERS TO RESTRUCTURE CURRENT ADMINISTRATIVE PROCEDURES WHICH ARE HIGHLY EFFECTIVE AND ECONOMICAL FROM THE VIEW POINT OF BOTH THE BROKER AND THE DEPOSITORY INSTITUTION. A RESULT OF THIS REGULATION COULD BE TO ELIMINATE INSURED BROKERED DEPOSITS. THE MOST LIKELY PRACTICAL EFFECT OF THE PROPOSED REGULATION WILL BE TO SIGNIFICANTLY INCREASE THE EXPENSE OF ACQUIRING BROKERED DEPOSITS, WHILE OVERLOOKING THE POTENTIAL PROBLEMS ASSOCIATED WITH THE MISUSE OF BROKERED FUNDS BY WEAK INSTITUTIONS.

SEARS ENDORSES THE APPROACH TAKEN BY CONGRESSMEN GARCIA, SCHUMER AND BARNARD IN H.R. 107. THE PROPOSAL ADDRESSES THE CONCERNS OF REGULATORS ON THE POTENTIAL MISUSE OF BROKERED FUNDS WHILE PROVIDING FOR CONSTRUCTIVE USES OF SUCH FUNDS.

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*50 FED. REG. 19185 (5/7/85)

TO BEGIN WITH, THE BILL LIMITS AN INSTITUTION'S ABILITY TO ACCEPT SHORT-TERM BROKERED DEPOSITS TO 15% OF ITS TOTAL DEPOSITS. WE BELIEVE THAT PROVISION ALONE WOULD REDUCE MOST MISUSES OF BROKERED DEPOSITS. H.R. 107 DOES NOTHING TO HAMPER THE LONG-TERM BROKERED FUNDS MARKET WHICH IS SO VITAL TO THE ASSET AND LIABILITY RESTRUCTURING EFFORTS OF THE THRIFT INDUSTRY. ONLY BY PROPER RESTRUCTURING EFFORTS WILL THRIFTS REGAIN VIABILITY AS AN INDUSTRY.

FEDERAL POLICY REGARDING DEPOSIT INSURANCE

H.R. 107 IS CONSISTENT WITH FEDERAL POLICY REGARDING DEPOSIT INSURANCE. IN FACT, SEARS BELIEVES H.R. 107 WILL ACTUALLY HELP REDUCE POTENTIAL DRAINS ON INSURANCE FUNDS MAINTAINED BY THE FDIC AND FSLIC. FIRST, BROKERED DEPOSITS COULD BE USED BY DEPOSITORY INSTITUTIONS AS A VEHICLE TO BECOME STRONGER BY BEING BETTER ABLE TO MEET FUNDING NEEDS. SECOND, BY LIMITING THE AMOUNT OF SHORT-TERM BROKERED FUNDS OR SO-CALLED "HOT MONEY," WHICH ARE MOST PRONE TO BE USED BY TROUBLED DEPOSITORY INSTITUTIONS, H.R. 107 REDUCES THE POTENTIAL OF LOSSES TO THE DEPOSIT INSURANCE FUNDS.

PASSAGE OF H.R. 107 SHOULD BE ACCOMPANIED BY RENEWED EFFORTS BY BANK REGULATORS TO ENFORCE REGULATIONS DESIGNED TO MAKE SURE THAT INSURED INSTITUTIONS CONDUCT THEIR BUSINESS IN A SAFE AND SOUND MANNER.

IN SUMMARY, SEARS BELIEVES THAT H.R. 107, IF IT IS PASSED AND RIGOROUSLY ENFORCED, WOULD GO A LONG WAY TO ALLEVIATE THE POSSIBILITY THAT MISMANAGED DEPOSITORY INSTITUTIONS COULD PUT A BURDEN ON THE FEDERAL DEPOSIT INSURANCE SYSTEM THROUGH THE MISUSE OF BROKERED DEPOSITS. ANY OTHER APPROACHES, PARTICULARLY THOSE AIMED AT ELIMINATING OR SEVERELY CURTAILING DEPOSIT INSURANCE FOR BROKERED FUNDS, WILL HARM RATHER THAN HELP DEPOSITORY INSTITUTIONS, THE ECONOMY, AND CONSUMERS.

WE COMMEND YOU MR. CHAIRMAN AND MEMBERS OF THIS SUBCOMMITTEE FOR CONDUCTING THIS IMPORTANT HEARING ON THE ISSUE OF BROKERED DEPOSITS.

ON BEHALF OF SEARS, ROEBUCK AND CO., WE PARTICULARLY WANT TO THANK CONGRESSMEN GARCIA, SCHUMER AND BARNARD FOR THEIR VERY POSITIVE AND CONSTRUCTIVE CONTRIBUTION TO RESOLVING THE CONCERNS THAT SURROUND THE ISSUE OF THE DEPOSIT INSURANCE SYSTEM WITH REGARD TO THE USES OF BROKERED FUNDS.

THANK YOU FOR YOUR ATTENTION. DICK REIBMAN AND I WILL BE PLEASED TO DO OUR BEST TO ANSWER YOUR QUESTIONS.

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Telephone (212) 524-2487

RAYMOND V. THOMAS
First Vice President
Assistant General Counsel

August 7, 1985

Hon. Carroll Hubbard, Chairman
Subcommittee on General Oversight and
Investigations of the House Banking Committee
U.S. House of Representatives
Room B-304
Rayburn Office Building
Washington D.C. 20515

Chairman Hubbard:

We wish to take this opportunity to supplement the record of our testimony before your Subcommittee on July 16, 1985 concerning H.R. 107, the "Brokered Deposit Limitation Act".

Mr. William Isaac, Chairman of the Federal Deposit Insurance Corporation, in his testimony before your Subcommittee and in Schedule A to his written submission, indicated that Dean Witter Reynolds Inc. had acted as a deposit broker for deposit accounts in a failed FDIC insured institution, Girod Trust Company of San Juan, Puerto Rico.

We wish to present, based on Dean Witter Reynolds' business records and on information received in the normal course of business, accurate information to correct inaccuracies in Mr. Isaac's testimony.

On August 16, 1984, Girod Trust Company was placed in receivership by the Secretary of the Treasury of the Commonwealth of Puerto Rico. The Federal Deposit Insurance Corporation was appointed receiver for Girod Trust Company. At the time Girod Trust Company became insolvent, Dean Witter Puerto Rico Inc., a subsidiary of Dean Witter Reynolds Inc., had $7.5 million of funds on deposit in Girod Trust Company. These funds were invested in certificates of deposit which were owned beneficially by Dean Witter Reynolds Inc. These deposits did not represent brokered deposits but were a direct investment by Dean Witter Puerto Rico Inc. for its own account. Dean Witter Puerto Rico Inc. is engaged in dealing in securities and entering into repo and reverse repo transactions with banks, savings and loans and corporations in Puerto Rico. It is not engaged in brokering deposits.

According to newspaper stories published in Puerto Rico at the time Girod Trust was closed, the bank was under examination by the FDIC because of capital inadequacies due to non-performing or questionable loans.

Thus, the characterization of the deposits referred to in Mr. Isaac's testimony was inaccurate. In addition, the hearings record should reflect that, to our knowledge, no representative of the FDIC attempted to verify this information with Dean Witter Reynolds Inc. prior to presenting it at the hearings.

Dean Witter Reynolds Inc. has attempted in its brokered deposit program to maintain sound standards of review of the institutions in which it places brokered funds. While such a system is not infallible -- partially due to the lack of information generally available regarding depository institutions -- Dean Witter Reynolds Inc. has endeavored to implement standards of market discipline such as Chairman Isaac has advocated in the past.

We appreciate this opportunity to respond to the Subcommittee on this important issue.

Very truly yours,

Raymond V. Thomas

Chairman HUBBARD. Thank you very much, Mr. Thomas, for your testimony.

Now questions of the three of you, Mr. Falzon, Mr. Reibman, and Mr. Thomas, with each member limited to 5 minutes, but chances for repeated questioning on further rounds.

To Manny Falzon of Merrill Lynch, Chairman Bill Isaac testified earlier here today that there is no difference between short-term and long-term brokered deposits with respect to the risk to the FDIC Insurance Fund. He told us they are the same.

The question is why is Merrill Lynch so adamant in opposing limits on longer term brokered deposits with maturities of more than 1 year?

Mr. FALZON. There are several reasons why, not only Merrill Lynch but the industry and other regulators do differentiate between short- and long-term deposits.

First of all, Cates Consulting Analysts, Inc. conducted a survey in which they looked at bank and thrift failures from 1981 through 1984. They found the primary cause of thrift failures was mismatching liabilities and assets, resulting in negative interest rate margins.

They found that over 90 percent of the thrift failures were as a result of negative interest rate margins.

The failure to match liabilities with assets. Borrowing short. Lending long, gambling on interest rates.

In addition to that, as I said other regulators do realize there is a difference between short-term and long-term deposits. For instance, the Federal Reserve assesses reserve requirements on deposit liabilities. There is a 3-percent reserve requirement for maturities out to 18 months. For 18 months or longer, it is zero, encouraging banks to lengthen liabilities because they recognize the soundness of extending one's maturities.

Also, if you look at the early withdrawal penalties on deposits, there is a much lower interest rate penalty on any deposits withdrawn out to 1 year than for those deposits beyond 1 year. So the Fed, the insurance agencies themselves, and certainly the industry recognizes the difference between short-term and long-term deposits.

Another difference between short- and long-term is this: in order to sell longer term CD's 1 year or more we need—when I say we, and other recognized Wall Street brokerage firms who sell to individual depositors—need to provide liquidity. There is no, guaranteed early withdrawal privilege for depositors when they buy a negotiable CD. If they require liquidity because they have to raise funds to buy a house, or to pay for their children's education, one way they can have access to this is to sell their CD back to the brokerage firm.

Now, in order to facilitate this secondary market we are at risk. Merrill Lynch is at risk. Sometimes considerable risk. We could have to up to a hundred million in our inventory in our own name, in individual thrift and bank names ranging from $1 million to $15, $20, or $25 million, where we are only insured for $100,000.

If the willingness of the dealers weren't there—the recognized Wall Street dealers—to buy the CD's, the secondary market wouldn't exist and there wouldn't be a longer term primary CD market. The money brokers sell CD's to credit unions, banks, and thrifts, who only invest in 30- or 60-day CD's and don't require liquidity because they are short-term.

The statement by Chairman Isaac referencing that the Wall Street firms do not accept risk and there is no credit risk is absurd, and is just untrue.

Chairman HUBBARD. Thank you. How about Mr. Reibman, or Mr. Thomas, answering the same question? Why are you so adamantly opposed to limits on longer term brokered deposits with maturities of more than 1 year?

Mr. REIBMAN. I think we would agree with the comments of Mr. Falzon, but we would emphasize that we mentioned earlier we separate this market into three different segments, two institutional, one is insured, one uninsured. It is the insured institutional area that we are dealing with here and saying that in shorter maturities it is possible to go into the insured institutional market and fairly rapidly build up a large volume of CD's being issued.

The insured, what we call retail market, is both short-term and long-term, but there is no long-term market for the institutional insured CD's. So it is a further subset, if you will, by types of market, and we think abuses have not occurred in the retail arena because we are obligated to make secondary markets, knowing that we have to do that and therefore be prepared to absorb losses if there were a failure; we maintain very stringent credit controls in all maturities, but of course the abuses that are alleged we believe have been limited to the shorter maturities.

Chairman HUBBARD. Mr. Falzon, how reliable is the pledge you expressed to us today that Merrill Lynch will repurchase certificates of deposit. Is this a business decision to which you are fully committed?

Mr. FALZON. It is a business decision we have made to service our individual investors, the individual clients who buy CD's from us. Although we are not contractually obligated to buy back any specific CD, they do rely on Merrill Lynch to make a market a secondary market in these instruments in much the same way we have made a secondary market in the institutional market on uninsured CD's, commercial paper, bankers' acceptances.

We have been in the securities business, as the largest security dealer for many, many years, so it is our reputation that our clients have come to trust and feel that we will be there on an ongoing basis to make these markets.

Chairman HUBBARD. One last question to Mr. Reibman or Mr. Thomas. Does Dean Witter stand ready to repurchase CD's as Merrill Lynch?

Mr. REIBMAN. Yes, we do, we consider this very important as a factor to get the retail sector to buy the CD as that is an inducement to have them participate in this market.

Chairman HUBBARD. Congressman Parris.

Mr. PARRIS. Thank you, Mr. Chairman.

To follow up on that, as I understand Mr. Thomas' testimony, he indicated that you do make some sort of adequate determination of the legitimacy, financial solvency is a better phrase, of the institutions you deal with. I can relate to that, particularly when you inventory the CD's in a repurchase arrangement. Can you share with us, have you had any losses in that market?

Mr. **Reibman**. We have not sold certificates of deposits in the retail CD program for any institutions which have required use of insurance funds from FDIC or FSLIC, nor have we sold certificates of deposits in any institutions which were subsequently merged with another institution.

So our credit procedure so far protects us from that. So we have not had any losses. But clearly if——

Mr. **Parris**. Have you had any instances in which you repurchased an inventory of CD's that had been previously issued?

Mr. **Reibman**. Yes, we have a very active secondary market.

Mr. **Parris**. Have you experienced any losses in that market?

Mr. **Reibman**. We have experienced losses in the sense that when you inventory any fixed income security, you have a market risk because of movements in interest rates. We have experienced losses in that sense just as we experience sometimes gains as a result of that.

It is not a function we perform as a profit-making enterprise in and of itself. It is a service function we perform to supplement really the marketing of CD's in the beginning.

Mr. **Parris**. OK.

What you are really doing is guaranteeing an after-market, irrespective of interest rate fluctuations. That is what it amounts to, isn't it?

Mr. **Reibman**. Yes, sir, that is correct. We are guaranteeing a secondary market at whatever the current interest rates are at the time. If you bought a CD with a 14 percent interest rate 2 years ago and it had 3 years to maturity, you would be able to sell that today for more than you paid for it at the time you bought it, but conversely if you bought a CD with a low interest rate in today's market, you would be selling at a discount. It does provide you with liquidity. It is important in showing that this interfuses the discipline of market forces to what we are doing and what the investor is confronted with.

It is not a market that is completely isolating someone from forces of interest rates. I think you may—someone made the point there are interest rate risks and there are credit risks also. The credit risk factor we have managed to avoid so far, but the interest rate arena is still very much in play.

One is exposed to that.

Mr. **Parris**. Mrs. Fairbanks, in her testimony, states in part that brokering operations have sought to create the impression that money brokerage has wrought no harm on the deposit insurance system in reality, and she goes on to say speaking on behalf of the FSLIC and Federal Home Loan Bank Board, money brokers in the brokered funds suggested they were simply innocent bystanders and harmless participants in the death dance of failed and failing institutions.

And she says, if you believe that, you are likely to believe in fairy tales.

That is a pretty strong statement from the Federal regulatory agency.

You gentlemen are in the delivery of financial services in this Nation and in a big way, Sears, Roebuck in my view is the largest financial institution in the world, even though it doesn't have reserve requirements and some other things that some people would like to have it have.

But if the statement by the Federal Home Loan Bank Board is true, if it is true, wouldn't that frighten you? Don't you think there is a fundamental problem here? Perhaps not in your operation.

I am not trying to whitewash brokered deposits. I hope you—I don't know if you gentlemen were here when I made my opening statement this morning, but if there is a problem of some magnitude, don't we have to try to address it? Do you agree with the principle?

I gather from Mr. Thomas'—perhaps I am answering my own question—you support H.R. 107 I think it is, in terms of a legislative approach. If this is true, wouldn't that give you some real pause?

Mr. **Reibman**. The fact that we devote so much attention to our own credit reviews, I think, demonstrates that we are aware there is a potential for abuse. I think we feel that the way we and Merrill Lynch and certain others conduct their programs is responsible in avoiding what could be these potential abuses.

H.R. 107 which we support, we think, would also assist in preventing abuses.

Mr. **Parris**. Thank you.

Mr. **Thomas**. I think also, as the testimony indicated, there has to our knowledge really been no demonstration of cause and effect. To characterize the broker as an innocent bystander to the death dance of the institution doesn't suggest to me, even if it is true, that he has contributed to the disease that afflicts that institution.

Mr. **Falzon**. Clearly the facts point out it is just not true. Among bank failures from January 1, 1982, through June 30, 1985, 66 percent of all bank failures had zero brokered deposits and another 22 had brokered deposits of less than 7 percent of their total deposits, an insignificant amount, which means 73 percent of all bank failures had zero or insignificant amounts of brokered deposits.

How could they say there is a causal relationship between brokered deposits and bank failures?

The same on the thrift side. One hundred sixty thrifts failed between January 1, 1982, and June 30, 1985. One hundred sixteen of the 160 had no brokered deposits. Another 24 had less than 5 percent of their deposits in brokered deposits. So therefore 84 percent of all the thrifts who failed in this 3.5 year period had zero or insignificant amounts of brokered deposits.

There is just absolutely no causal relationship between the two.

Mr. **Parris**. I agree with the first part of your comment, Mr. Falzon, I am not sure I agree with your conclusion.

What you are suggesting is that because a small number of brokers with a fairly large number of deposits, but still a fairly insignificant amount when you are talking about the trillion-and-a-half dollars of total deposits in the financial institutions of this Nation, you know, what you are suggesting is that because a few of those people are taking advantage, if you will, of the mismanagement of a few institutions, that what we have to be careful with is throwing out the baby with the bathwater.

I agree that that is a valid suggestion that we cannot and should not and I would not support elimination of brokered deposits. But it also seems to me that when we, as has been testified to, we have a situation where classified S&L's exceed by 400 percent the total assets in the insurance fund, if those classified institutions are—if their financial stability is exacerbated by brokered funds, if it is the last gasp as trying to make this thing work and you get these brokered deposits and pay whatever you have to and shoot craps with the investments in order to get yourself back on your feet. If that is what we are doing, I think we have to look at that and we have to deal with that.

Mr. FALZON. We agree, and we support H.R. 107 because it eliminates those abuses through the 3-percent net worth requirement, and the requirement that there be a limit on short-term deposits, because that is where abuses have taken place with institutional investors.

Mr. PARRIS. Thank you.

Mr. THOMAS. May I respond 1 minute further? I think the testimony here this morning would also show that the brokered deposits, even those brought in close to the liquidation or receivership of an institution, are not in any demonstrable sense related to the demise, but they are only one of the symptoms of that demise and that those symptoms may manifest themselves, as Ms. Fairbanks testified, as much as 2 years before that institution really becomes a regulatory case.

Frankly, I am more concerned about where the regulators are in that 2-year period than I am about the participation of brokers during the terminal illness of such an institution.

Mr. PARRIS. We share your concern with that, Mr. Thomas, and as has been said, the examination is an after-the-fact process which doesn't deal effectively with the problem.

Thank you, Mr. Chairman.

Chairman HUBBARD. We will now call on Congressman Doug Barnard for questions.

Mr. BARNARD. Thank you, Mr. Chairman.

I really don't have too many questions. I agree with what these fellows are saying. One of the problems that I think is just as much a problem if not more of a problem than brokered deposits is linked deposits. Unfortunately this morning, we didn't have time to talk to either of the regulators of their attitude about linking deposits with loans.

What is your attitude about that, Mr. Falzon. In your experience I don't presume that Merrill Lynch would ever carry a proposition to an institution where it would link a loan with the deposit, would it?

Mr. FALZON. That is correct. Anything that we do stands on its own and we don't engage in linked financing of any type.

Mr. BARNARD. Do you think that a prohibition on link financing would be in order to help solve problems of the brokered regulations?

Mr. FALZON. If the language was structured properly but it might be difficult to actually structure that provision.

Mr. BARNARD. I think it is going to be difficult to track a link operation. I can see where a party A could bring in a large CD and the bank would have to make a loan to party B and yet you would have a difficult time tracking that, but if bank regulators could track that, to me that would be a far more dangerous practice than just marketing of and purchasing of brokered funds.

Mr. FALZON. We agree. Certainly as you inferred in your question, the Merrill Lynchs of the world wouldn't become involved with that kind of a practice, because we have a reputation to think of and our individual clients who buy the CD's and of course the CD market in general, would become greatly affected by that.

Mr. BARNARD. Mr. Reibman, as far as Dean Witter being in the Sears family there, do you all have occasion where there is any linking brokered funds with loans, such as would be made with your savings and loan operation?

Mr. REIBMAN. No, we are very aware of the fact that if we were to do such a thing, it would be readily apparent and we would be criticized for it.

Mr. BARNARD. There is no law that prohibits it now, is there?

Mr. THOMAS. I believe there is.

Mr. BARNARD. Is there a tandem law? I know there was in this H.R. 20 we just passed.

Mr. THOMAS. The provisions of the Federal Housing Act which govern savings and loan holding companies and insured subsidiaries thereof contain an array of prohibitions on transactions with affiliates.

They in effect mandate either that the transaction be one of a type that the Board by regulation has determined previously does not pose any potential threat to the safety and soundness of the institution or, alternatively, that it must be cleared with the regional Bank Board before that transaction could be entered into.

Mr. BARNARD. What is your feeling about linking brokered funds with loans?

Mr. REIBMAN. I think that if what one is dealing with is simply reinvestment of funds brought in, if you sold $10 million in CD's and they bought $10 million in Ginny Maes, there would be no problem in that transaction.

The abuses that have occurred or alleged to have occurred have been where a broker came to an institution and said, I have a lucrative investment opportunity for you, and it was in terms of creditworthiness very substandard, and that induced the financial institution to issue the CD's to generate the funds to invest in that particular linked transaction. In those instances that have been pointed out in the press, they seem to be things that we should all, as much as we can, avoid. We have not been a party to anything like that nor have any major participants in the market that I am aware of.

Mr. BARNARD. I have no further questions, Mr. Chairman.

Chairman HUBBARD. Thank you.

Now we call on Congressman Henry Gonzalez for questions.

Mr. GONZALEZ. Thank you very much, Mr. Chairman. I thank the three gentlemen.

One question I have was what has been the history of the type of activity that you have testified on since the 1982 so-called Garn-St

Germain Act? Has that been a sort of a threshold period after which you had incremental activity?

Mr. **Falzon**. The real threshold for us and all the individuals that we service really came through the deregulation of interest rates out of DIDC for amounts less than $100,000. That enabled individual savers to receive market rates and competitive rates of interest like institutional investors in the million and up category were receiving for decades.

Also, with that they enabled the instrument or the deposit to be negotiable. That really was the beginning of the negotiable market because we could sell in amounts of less than $100,000 at market rates and it had negotiability. DIDC therefore must have had brokers in mind and dealers in mind when they set forth negotiability to be a feature of those unregulated deposits because you cannot have negotiability unless you have marketmakers willing to buy the CD's.

So it was the DIDC that really established it.

Mr. **Gonzalez**. That was immediately preceding the 1982 Garn-St Germain bill, not too long before that, and with the advent of deregulation and the growth of the money market activity, which I think represents a period in which the basic 1935 Banking Act played out.

But what I am interested in is sort of an overarching legislative background. It is fine to consider individual ad hoc enactments which would be represented in H.R. 107, for example. But I believe that after the occurrences and the actions taken with respect to the failure of the Continental Illinois, and the fact, where for all intents and purposes, you had an assumption of liability for both insured as well as uninsured—we don't call it that, but really the nationalization of that financial institution—all without any kind of congressional action, I still feel that the proper interpretation of the statutes would have mandated the Federal Reserve seek congressional assent to that, because after that precedent the only thing we can say is that in case of insured or uninsured distinctions that those have been erased or blotted out, and that it all depends on how large the financial activity involved is to bring about a complete assumption of that liability and risk on the part of the money managers of our Government.

The other question I had was with reference to the presence of foreign investors in your category of business. Do you have any, or is there such a thing as foreign-originated investments seeking brokerage?

Mr. **Reibman**. The majority of the institutions for—well, actually all the institutions for whom we sell CD's are domestic institutions.

Mr. **Gonzalez**. They are all domestic?

Mr. **Reibman**. Yes, sir. There are one or two whose stock is owned by foreign institutions. I believe Crocker National Bank is owned by Midland Banks of Britain.

Mr. **Gonzalez**. That is right.

Mr. **Reibman**. But it is also, almost without exception, a completely domestic circle of issuers and investors.

Mr. **Gonzalez**. All right.

The critics of the brokered deposit state with a great deal of frequency that if distinctions are made between long- and short-term deposits, long-term brokered deposits would flee the troubled institutions at the first sign of trouble.

Is that true, or is that likely to happen, or is there ample reason to fear that criticism or that occurrence?

Mr. REIBMAN. Certainly, that is one of the reasons we are very careful in our own credit check, because we believe if there are rumors of trouble at a particular institution, and if we were obligated to make a secondary market in that institution's CD's, we would be asked to purchase; there would be an imbalance of orders, more sellers than buyers. Since we are interested in avoiding that situation, it is a very strong discipline for us.

Mr. GONZALEZ. It seems to me what we have in this country is sort of a jungle in which it is every man for himself; let the devil take the hindmost. You are playing in that jungle. You have the law of the jungle. You don't have any rules since deregulation. So that I am looking at it from the legislative standpoint now.

What do we now do? Is it too late to consider even a basic overarching policy that would be setting some discipline?

The Garn-St Germain Act was a final act in homogenizing our financial institutions. Everybody is a bank today—credit unions, S&L's. And the banks want to be everything else. So, in the absence of something that I would define as an overarching national policy, I believe that as desirable as it may be to have this ad hoc legislation—which is the way I would define H.R. 107—that you are playing still in a jungle, and that you will be exposed with no rules there to being victimized sooner or later by the more powerful.

I just want to compliment you, though, on staying alive thus far. I hope you will.

Mr. FALZON. So do we.

Chairman HUBBARD. Thank you, Congressman Gonzalez.

My final few questions to Dean Witter's representatives, Mr. Reibman and Mr. Thomas, on page 7 of your prepared testimony you state:

> Dean Witter conducts a comprehensive analysis of the financial soundness of a depositor institution for which its brokers deposit. The analysis of potential certificate of deposit issuers is identical to that Dean Witter performs when it extends credit to another institution.

What is the reason or the rationale for that effort if, in fact, the certificate of deposit is fully insured by the FDIC or FSLIC?

Mr. REIBMAN. There are several reasons for it. One is that, as we mentioned earlier, we are obligated to make a secondary market in those activities. If we were to own as principal more than $100,000 worth of CD's, we would be at risk on those. So that if the institution failed, we would have a loss beyond the $100,000 amount. So, we are ourself at risk to that extent.

Another reason is that, even though the Federal deposit insurance has proven to be very effective in preventing runs on banks because of rumors, it is nevertheless viewed as an undesirable situation to have to call upon Federal insurance. If an investor buys a CD and some period of time later that institution fails and has to be rescued, that is viewed as a negative event by the investor.

He is also possibly going to invest it in a high-yield certificate and will now find himself funded out by the regulators at today's interest rates, and then reinvest at today's rates. So, we may get sued for that economic loss he incurred, even though he gets the principal amount back.

I could elaborate on several other things in the same vein, but the point is that we don't view Federal deposit insurance as absolving us of any potential economic loss. We think it does not do that for Dean Witter.

Mr. **Thomas**. As a matter of fact, in the credit review process it is the same process we go through with those institutions for which we will engage in repurchase transactions, a form of financing, for savings and loans. But the criteria now applied to the institutions for which we will broker retail certificates of deposit are somewhat more rigorous to the extent that, while approximately 50 percent of the institutions in the repurchase market today would pass muster with our credit department, only approximately 10 percent of those institutions who have sought to broker deposits through us have been cleared by our credit department.

Chairman **Hubbard**. Again to Mr. Reibman or Mr. Thomas, is your position that most bank failures are those where the bank has a large percentage of short-term brokered deposits? Is that your feeling?

Mr. **Reibman**. Our position would be the opposite; that most financial institution failures—to include S&L's, as well—occur where there has been mismanagement, either fraudulent or incompetent management, and not a large percentage of brokered deposits being part of the liability structure of the institution.

Chairman **Hubbard**. Thank you.

One last question, if you would, to Mr. Falzon.

What percentage of Merrill Lynch's brokered deposits business comes from longer term brokered deposits with maturities of more than 1 year?

Mr. **Falzon**. The maturities of 1 year or more, it is about 93 percent. For maturities beyond 1 year, it is 86 percent.

Chairman **Hubbard**. Congressman Parris?

Mr. **Parris**. No questions, Mr. Chairman.

Chairman **Hubbard**. Congressman Gonzalez?

Mr. **Gonzalez**. Just one thing here. In your credit checks, I find that—at least, I think, in my home State, at least—we have a day of reckoning particularly in S&L's where you really had in the basic capitalization and assets—you have, depending on how the accounting is made, in effect jerry-built type of assets that are used in order to, in effect, negotiate either greater credit enhancement or asset enhancement, but which is really only on paper, and that is, in effect, based on an inflated and in fact almost fraudulent value of original land holding.

What is to prevent you from being victimized unless you have very superior means of credit channels and accounting methods that coincide with a fairly uniform acceptance standard?

Mr. **Reibman**. You make a very good point in that it is not sufficient to merely rely upon the most readily available financial reports. Almost without exception, we find it necessary physically to visit a prospective issuer and personally interview management; in some cases, to inspect properties, to make samples of recordkeeping practices on the part of the institution. So, it is time consuming and expensive to develop these types of credit procedures. But we believe them to be very necessary because of the possibility for such things as you have described in your question.

Mr. GONZALEZ. I am happy to hear that, because it means you are a good, sound, prudent banker.

Mr. REIBMAN. Thank you.

Mr. GONZALEZ. In the traditional sense.

Thank you very much.

Thank you, Mr. Chairman.

Mr. REIBMAN. Thank you.

Mr. PARRIS. Will the gentleman yield?

Mr. GONZALEZ. Certainly.

Mr. PARRIS. They are not in the banking business; they sell refrigerators.

Mr. GONZALEZ. But that is what I say. The Congress has obliterated that distinction.

Mr. REIBMAN. I have a catalog with me, if you wish.

Mr. GONZALEZ. Oh, I am a Sears customer. Not only catalog, but local.

Chairman HUBBARD. Thank you very much, Mr. Falzon of Merrill Lynch.

We are glad to have you three gentlemen to be with us to testify. Mr. Thomas, Mr. Falzon, Mr. Reibman, thank you for your answers. We appreciate your being with us.

We turn to our third and final panel: Bill Goldsmith, executive vice president of Professional Asset Securities, Inc., of Del Mar, CA; and Jorge Coloma, president of FAIC Securities, Inc. of Miami, FL.

We will ask Mr. Goldsmith to present your testimony first. We thank you for your appearance here today. Your statement will be submitted and included in the record.

STATEMENT OF WILLIAM A. GOLDSMITH, EXECUTIVE VICE PRESIDENT, PROFESSIONAL ASSET SECURITIES, INC.

Mr. GOLDSMITH. Thank you, Mr. Chairman.

I don't have an office in Virginia, and I don't live there, nor in Texas, nor in Kentucky; but I love those States. We have clients in every one of those States, by the way.

Thank you for inviting me. My presentation this morning will cite studies from the House Committee on Banking, a study from Cates Consulting of New York, a study from Golomb Bay & Associates of Washington; and, in addition, references to former Comptroller of the Currency Conover, former Senator John Tower, Morgan Guaranty survey, the Honorable Fernand J. St Germain, the Honorable Attorney General Edwin Meese III, U.S. Department of Justice representatives, the Honorable Edwin J. Gray, Alan Whitney of FDIC, and others.

Discussions by the regulators this morning—Mr. Isaac, Mr. Selby—and for the past 3 years on the perils of the insurance system, seem to me always begin with a conclusion before identifying the problems. Now, they have repeated their cries for so long that they seem to even convince some of my colleagues who have testified this morning.

It has been suggested elsewhere that we first isolate the problems before recommending the solution. It seems that Mr. Isaac and Mr. Gray's approach can be likened to a doctor with a sick patient who tells his patient to take two aspirin and go to bed, and then asks the patient what ails them.

Now, it is my contention that banks and thrifts fail for three main reasons. No. 1, banks fail because they are mismanaged. In Time magazine, December 3, 1984, Mr. Isaac said: "Bankers got many of their current problems the old-fashioned way: They earned them."

David Cates, the highly regarded bank and thrift analyst and head of Cates Consulting, quoted in the American Banker, May 29, 1985, says that, "Banks fail, quite simply because of mismanagement."

No. 2, more commercial bank and thrift failures are due to fraud than for any other single reason. Attorney General Edwin Meese III announced plans for a multiagency attack on bank fraud, which he said had been a factor in more than half of the bank failures in recent years. Mr. Meese said that in 1984 there were 79 bank failures and 27 failures of savings and loan institutions, a record number since the beginning of Federal controls in 1930.

According to a Justice Department survey of 75 FDIC-insured banks that failed between 1980 and 1983, 61 percent involved actual or probable criminal misconduct by bank insiders.

Mr. Gray added, in the April 30, 1984, American Banker, that the failure of Empire Savings in Texas was the result of one of the most reckless and fraudulent land investment schemes ever encountered by the Federal Home Loan Bank Board.

Three, regulatory ineptness has been a contributing factor in recent bank and thrift failures. Regulatory ineptness contributed to bank failures. Said David Cates:

> Of those banks that failed during 1981-83 period, only 37 percent had an adverse rating based on the last exam before failure, and 34 percent got a clean bill of health from regulators on their last exam prior to collapse.

In the Wall Street Journal of July 16, 1982, which quoted Fernand St Germain, chairman of the House Banking Committee, on the closing of Penn Square Bank—and I quote:

> . . . hundreds of investors placed money in an institution which an agency of the U.S. Government knew to be unsound . . . public moneys were used to examine the bank, collective data to analyze the condition, but the public didn't receive the results of the work for which they paid.

In the New York Times of November 16, 1983, it states that a House committee reported on the collapse earlier that year of the Tennessee and Kentucky banking empire controlled by the Butcher brothers criticized the staff of the FDIC for "extreme regulatory neglect" in failing to take stronger action against the bank's senior officials, and that Jake and C.H. Butcher engaged in an unrelenting series of unsafe and unsound and unconceivably unlawful banking practices over 6 years.

Alan Whitney, a spokesman for the FDIC, said, "* * * the agency would be the first to admit that we made a mistake in supervising United American Bank."

As we all know, Jake Butcher has pleaded guilty to charges of fraud and has been sentenced to three 20-year terms in a Federal penitentiary.

Edwin Gray of the Federal Home Loan Bank Board admitted in congressional hearings in 1984 that his agency may have been able to prevent Empire's failure if it had acted faster and more decisively. Yet, the FDIC and the Home Loan Bank Board would have us believe that all the problems with banks and thrifts today begin and end with brokered deposits, when, in fact, according to a recently completed study by Ray Garea of Cates Consulting, only 7 percent of all deposits from all bank failures from January 1, 1984, through September 30, 1984, were brokered funds. That source indicates that the percent of unbrokered funds in failed institutions in the United States were in greater abundance than brokered funds.

The Morgan Guarantee study of 1984 states that: "Even if brokered deposits were banned altogether, depository institutions could continue to obtain funds by other means, such as more widespread advertising." However, if we must isolate a single source of deposit as a cause for thrift failures, consider that in 16 thrifts that failed from January 1, 1984, through September 30, 1984, 30 percent of earning assets were funded by purchase money from all sources, but 14 percent, almost half, were supplied by the various Federal Home Loan district banks. Yet, no one is seriously suggesting doing away with the district banks.

You can legislate out of existence brokered deposits or even put an arbitrary cap, but will that solve the concern of the regulators? The answer is a resounding no. Listen to the evidence taken from a House of Representatives Committee on Banking:

> This analysis concludes that there is neither concrete evidence nor a coherent argument that an insured deposit brokerage is inherently harmful to the banking system. Removal of the deposit insurance coverage for brokered deposits, as attempted by the agencies in their rule, cannot be justified by the evidence the agencies have presented, and it is also doubtful that capping every institution's holdings of brokered funds at some specific percent of deposits will have much effect.

It further states: "There is ample demonstration in the statistical material that, among problem institutions, rapid growth without brokered funds is much more common than rapid growth with brokered funds." In other words, funds appear to be readily available for institutions that are denied access to brokered funds. As a matter of fact, objective observers, Congressmen and women from both parties, and even Mr. Isaac, concede that brokered deposits and brokers provide a valuable service.

It is a fact that the 25 largest banks and thrifts hold about 30 percent of all deposits in the United States. If you limited brokered deposits, you would further consolidate deposits in the larger, too big to fail banks and thrifts. You would force well-managed banks and thrifts to rely on more costly alternative sources for deposits; would reduce the flexibility of bank and thrift managers to practice asset liability management techniques that can immunize an institution from interest rate risk in almost any interest rate environment.

You will reduce bank and thrift earnings at a time when positive spreads have narrowed to near record lows. You will raise the cost to consumers for all bank and thrift services. You will not prevent banks or thrifts from making bad loans or indulging in risk investments. You will not eliminate fraudulent or illegal banking practices or insider dealing; and you would not force regulators and examiners to act more quickly and prudently to stop these abovementioned practices.

There is no need to alter the deposit delivery system to capture an errant messenger. Mr. Gray and Mr. Isaac's horror stories concerning linked financing involved a few banks and allegedly one broker. While there are just as many bankers and many, many brokers who turn down linked proposals as those who bought it, if a few bankers or brokers break the rule, don't change the rule—throw the rule-breakers out of the game.

I seem to have a great deal of disagreement with what my colleagues on panel 2 from Merrill Lynch and Dean Witter said. I recall, when Mr. Wilson was chairman of the board of General Motors, his common phrase was, "What is good for General Motors is good for the United States."

It seems to me that the gentlemen on the panel 2 were saying, "What is good for Dean Witter and Merrill Lynch are also good for the United States."

Frankly, I don't find much distinction between individual and institutional deposits, or from short-term versus long-term deposits. Permit me to address these issues.

A credit union, a thrift, or a bank deposits funds in another bank or thrift. To those depositors, those become assets. To the receiving institutions, they are, of course, liabilities.

Now, the banks and credit unions and savings and loans who deposit these funds in other banks and thrifts collect these funds just as Merrill Lynch and Dean Witter does from hundreds of thousands of individual customers, comingling them and making deposits. If there is going to be a distinction made, why make it against an institution who is doing exactly the same thing that Merrill Lynch is doing?

As to long-term versus short-term funds, Mr. Falzon and others—and H.R. 107—seem to have forgotten that interest rates go down as well as up. In the last 12 months, those banks that issued long-term CD's—and the longer, the worse—are in much worse shape than those banks and thrifts who relied on short-term liabilities, because interest rates, as you all know, have gone down considerably since last July. Those institutions who were buying short-term funds because that was their best educated judgment on the direction of interest rates, today are in a much better position than those who bought long-term funds.

Now, Professional Asset Securities, as to analyzing institutions, has only once in its history brokered funds to a failed institution. Now, as an NASD firm, we analyze institutions before we work with them. And, as the others have mentioned, we will turn down probably two-thirds of all institutions who ask us to work with them. Our analysis works, and we have an early warning system that enables us to stop extending funds when trouble looms, providing we can obtain the sound financial data on a timely basis.

Mr. Isaac and Mr. Gray seem to forget conveniently that in the period of 1981 through 1985 when there have been more bank and thrift failures, than in any period since the depression, we have had record high interest rates, a depression in the oil patch, a recession in the real estate industry, and a catastrophe in the farm belt. Were none of the above responsible for troubled institutions or were all the problems caused by money brokers?

In spite of that, we believe that some legislation is necessary to deal with the concerns of the regulators and Members of the House and Senate because in the absence of legislation we have had well meaning but disruptive regulation and lacking either legislation or regulation, the Nation's banks and thrifts are being subjected to a well calculated campaign of intimidation by FDIC and FHLBB field examiners against the use of brokered deposits—not only the so-called weak institutions, but also the well managed banks and thrifts that meet or exceed regulatory minimum standards.

The result of this intimidation—from interviews with close to 100 officers of banks and thrifts in the last 3 months—has been a shift away from brokered deposits to other sources of deposit, and an increase in the cost of deposits from 50 basis points to 150 basis points, this at a time when spreads are narrower than at almost anytime in the history of banking.

Not only have the FHLBB and FDIC, through their highhanded tactics, forced profitable and well capitalized banks and thrifts to pay more for deposits at the very time when competition and deregulation have reduced yield spreads to the slimmest of margins, public comments by Mr. Isaac and Mr. Gray receive wide media exposure that is almost always confusing, usually disruptive and sometimes untrue.

If I, as an NASD registered principal, or if registered representatives from any NASD firm resorted to the kind of hyperbole to sell stocks or bonds that the regulators employ to prevent banks and thrifts from issuing CD's and investors from buying CD's, we would be reprimanded at best, and lose our license at worst. And what do the regulators get—nationwide media headlines.

For example, on June 17, 1985, Mr. Isaac threatened to withhold payment on insured deposits at a failed Wisconsin bank because "the agency suspects fraud" and a "possible" suspect was a money broker who directed $1.1 million in brokered deposits to said bank in a "possible linked financing" arrangement. The story got national headlines. But the real facts are that the bank was having major problems long before there were any brokered deposits.

In 1984, the bank lost $402,000 after losing $459,000 in 1983. At the time of its closing bad loans exceeded capital by twentyfold and were more than 23 percent of total loans. The bank had total deposits of approximately $20 million when it closed, and only $1.1 million in brokered deposits. And finally, an officer of the failed bank has been charged with writing a check for $2.6 million on an account with only $200, then deposited the check in a Canadian bank, then immediately transferred the proceeds to other accounts.

But the only story that got headlines was the Isaac fable. Mr. Isaac made his threat knowing he could not carry it out in a further effort to discredit brokered deposits. Even if the truth were known, the damage to the market was done.

Irresponsible actions on the part of agencies and their examiners must be curtailed. Depositors, investors, banks, and thrifts, the market generally, urgently needs legislation.

Mr. Chairman, you can, with legislation, address all the concerns you and the regulators may have concerning problem banks. The concerns of the regulators have been articulated by Mr. Gray:

These concerns were summed up by Chairman Gray of the FHLBB and reported on January 17, 1984, in the American Banker:

> The issue we take up today on the appropriateness of an unregulated financial entity collecting funds, charging a sizable fee, the placing of funds without regard to the safety and soundness of a recipient depository institution and without regard to the potential consequences for the Federal deposit insurance funds.

Therefore, based on our written testimony and supporting documentation we respectfully recommend the following suggestions as the basis for legislation on brokered deposits. We are confident that they meet and even exceed the stated concerns of the regulators.

First, register all brokers with the NASD. For more than 50 years, the NASD has been an effective regulatory body with a long and distinguished history in the regulation of the securities industry.

Second, require all brokers of certificates of deposit to deal only with commercial banks and thrifts which meet or exceed regulatory minimum standards. Brokers would be required to do a financial analysis of the institutions they perform a deposit brokerage service for, at least semi-annually. This analysis can be done in-house or purchased from one of several outside firms. Additional financial disclosure as called for by Chairman Isaac of the FDIC, but not endorsed by Chairman Gray, and more timely reporting would be helpful.

Third, require all deposit brokerage firms to report quarterly to the appropriate agencies the name of each institution for whom they provide service and the amount of dollars brokered during the preceding quarter.

Fourth, require all deposit broker firms to refrain from providing service to any institution which does not meet regulatory minimums without written permission from the appropriate agency. This will meet these special circumstances such as American Savings where the regulators asked a group of firms to raise $1 billion in deposits.

Fifth, brokers should be required to provide their client depositors with financial information on the financial strength and performance of the institutions receiving funds.

Sixth, institutions should be required to disclose information on their loan portfolios including a general description of the types of loans, percentage of loans in each category, and a disclosure on nonperforming loans in each category. Thank you.

[The prepared statement of Mr. Goldsmith on behalf of the Professional Asset Securities, Inc., follows:]

TESTIMONY OF
WILLIAM A. GOLDSMITH
EXECUTIVE VICE PRESIDENT
PROFESSIONAL ASSET SECURITIES, INC.
MEMBER NASD

BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON GENERAL OVERSIGHT
AND INVESTIGATIONS OF THE
COMMITTEE ON BANKING, FINANCE, AND
URBAN AFFAIRS
99th CONGRESS, 1st SESSION
JULY 16, 1985

THE HONORABLE
CARROLL HUBBARD, JR., KENTUCKY, CHAIRMAN

Mr. Chairman:

Thank you for this opportunity to discuss the issue of "Brokered Deposits" and to air not only our views and those of many in our industry, but also the views of those more acutely affected by your deliberations and legislation. We also speak for those who use brokers to aid in their search and selection of viable banks and thrifts for their investments, and for those viable, well-managed banks and thrifts who want and need access to a national marketplace for deposits on the most efficient, least costly basis possible.

It is our belief that some legislation is necessary because in the absence of equitable legislation, capricious and counterproductive regulations no matter how well-meaning, have filled the vacuum -- regulations that ultimately proved harmful to the very banks and thrifts these regulations were intended to assist. Even Chairman Issac has said that until and in the absence of legislation, he will use the regulatory powers at his disposal to solve in his way what he perceives as problems created by brokered deposits -- but expressed his desire for legislation to address the issue.

Further, it is our belief that legislation is the proper legal recourse since both a Federal District Court and a U.S. Court of Appeals declared that recent regulatory efforts to curb or eliminate brokered deposits exceeded the authority of the agencies that promulgated them and further declared that any solution to regulatory concerns, real or imagined, falls under the aegis of Congress.

And, finally, we believe that congressional legislation is the correct answer to concerns raised by brokered deposits, since it is Congress and not the regulatory agencies that is elected by and must answer to the constituencies legislation of this magnitude will affect: individuals, borrowers and investors; churches and other religious organizations; charities; cities, counties, and other government agencies; trade groups; corporations; retirement funds; senior citizens; commercial banks and thrifts as investors in and issuers of brokered CDs; credit unions. In one way or another, legislation on brokered deposits will touch almost every man, woman and child, Republicans and Democrats alike, in these United States.

We, of course, recognize that this legislation must address the concerns of the regulators, but it must also consider the needs of investors, individual and institutional alike, who use brokers and the smaller, less visable but well-managed banks and thrifts who rely on brokers to sell their CDs, and by so doing, "level the playing field" with the large money center banks and largest thrifts that can raise deposits with existing (but costly) extensive branch operations in this most difficult and competitive deregulated environment. And certainly legislation must satisfy the concerns and requirements of members of the Senate and the House since in the final analysis, it is their concerns that will shape the legislation.

We supported the section on brokered deposits in S-2851, 2nd Session, 98th Congress, authored by Senator D'Amato and Senator Mattingly as the best possible compromise based on the information then available. However, since the passage of S-2851, some enlightening facts have been compiled and published, which in our opinion is of such import and depth that we believe the section of S-2851 dealing with brokered deposits should be re-examined and amended in the light of these new facts. We feel that not only are there many reasons for a legislative solution to brokered deposits, but also the need for legislation is urgent. Soon after the regulators failed to win a legal challenge to their ill-conceived "brokered deposit rule", the FDIC and FHLBB began a well-calculated campaign designed to intimidate all banks and thrifts, including hundreds of highly regarded institutions, against the use of brokered deposits. In recent months and weeks, we have met with more than 100 officers of successful banks and thrifts who have given eloquent testimony to the pressure presently being exerted by FDIC and FSLIC field examiners against any use of brokered deposits. These banks and thrifts have turned to other sources for deposits such as their own money desks, national advertising and deposit listing services all of which have resulted in higher direct costs (from 50 to 150 basis points higher and considerable indirect costs such as staffing, paperwork and more). In several instances, these additional costs have reversed a positive net interest margin to negative net interest margin.

Without exception, these executives expressed a desire to be here with this panel to tell their story -- but would not be willing to do so for fear of reprisal from their regulators. It is for these banks and thrifts, and hundreds more and their customers, that we urge you to move legislation on brokered deposits with the utmost dispatch.

We would like you to recall the recent history before enumerating the facts we believe warrant a re-examination of an amendment to brokered deposit limitations in S-2851 and the amendments we propose. It has been said that it is necessary to understand the past in order to deal with the present.

In this context, then, it is important to remember that brokered deposits are not a new phenomena. In the early sixties, then City National Bank (now CitiBank) opened a new era in the acquisition of deposits when it began to sell jumbo CDs to investors nationwide and worldwide. While jumbo CDs had been marketed before the early sixties, it wasn't until a major Wall Street broker agreed to create a secondary market that this method of acquiring deposits became an important source of deposits. Soon after, most major money center banks and many of the regional "Top 100" followed the lead of City National. In as much as the U.S. banking system is the only one worldwide that permits the acquisition of loans through interstate offices while limiting the acquisition of deposits to intra state offices, it became apparent that this new source of deposits would increase in importance as major banks' assets grew more rapidly than in state branch-based deposits could accommodate.

In the late seventies and early eighties, many smaller, less visible, but well-managed banks and thrifts particularly in the rapidly growing Southwest and Western markets found stiff competition for loans from the major institutions. As a result, they too opened loan offices interstate resulting in a need to generate deposits in a national market place. Because of their size, they were effectively cut off from brokered deposits through the major Wall Street firms resulting in the growth of new firms to fill this vacuum.

Our firm, founded by two men with more than 25 years of (combined) experience with two major Wall Street firms, and with expertise in the capital and money markets (government and municipal securities, BAs and CDs), and a universe of small to middle market institutional clients, was established to fill the needs of those clients, some a source of funds (investors) and others as users of funds (CD issuers). Now the well-managed but less visible bank or thrift had a more "level playing field" and could compete with the larger money center institutions for loans and deposits on more or less an equal basis.

The new and more recent "phenomena" of money brokers, then, was a market driven one whose parents were a deregulated environment for assets and a vacuum of opportunities for liabilities for the smaller institution in a market dominated by large money center banks and thrifts, and the major Wall Street brokers who catered to their needs.

It is a fact that the 25 largest banks and thrifts control almost 30% of all deposit dollars. A limit on brokered deposits or even a cap on short-term deposits for well-managed, viable but smaller banks and thrifts would:

(1) Further consolidate deposits in the larger "too big to fail" banks and thrifts;

(2) Would force well-managed banks and thrifts to rely on more costly alternative sources for deposits;

(3) Reduce the flexibility of bank and thrift managers to practice asset/liability management techniques that can immunize an institution from interest rate risk in almost any rate environment;

(4) Reduce bank and thrift earnings at a time when positive spreads have narrowed to near record lows;

(5) Raise the cost to consumers for all bank and thrift services;

(6) Not prevent banks or thrifts from making bad loans or indulging in risky investments;

(7) Not eliminate fraudulent or illegal banking practices or insider dealing, and finally;

(8) Would not force regulators and examiners to act more quickly and prudently to stop these above-mentioned practices.

Are brokered deposits the cause of bank failures? In late 1983, and early 1984, Ed Gray, Chairman, FHLBB and William Isaac, Chairman, FDIC, alleged that brokered deposits were responsible for many of the problem institutions. But many banking experts plus the House of Representatives Committee on Government Operations, Cates Consulting, and even Mr. Isaac himself now says otherwise:

(1) In Time magazine, December 3, 1984, Mr. Isaac said, "Bankers got many of their current problems the old fashioned way -- they earned them. The common thread in the industry's trouble is bad management."

(2) David Cates, highly regarded bank and thrift analyst and head of Cates Consulting, quoted in the American Banker, May 29, 1985, says that, "Banks fail, quite simply because of mismanagement."

(3) Regulatory ineptness contributed to bank failures, said David Cates, "Of those banks that failed during 1981-83 period, only 37% had an adverse rating based on the last exam before failure and 34% got a clean bill of health from regulators on their last exam prior to collapse."

(4) The New York Times, November 16, 1983, states that a House Committee report on the collapse earlier this year of the Tennessee and Kentucky Banking empire controlled by the Butcher brothers criticized the staff of the FDIC for "extreme regulatory neglect" in failing to take stronger action against the bank's senior officials, and that Jake and C.H. Butcher engaged in an unrelenting series of unsafe and unsound and conceivably unlawful banking practices over six years. Alan Whitney, a spokesman for the FDIC said, "the agency would be the first to admit that we made a mistake in supervising U.A.B." (Jake Butcher has pleaded guilty to charges of fraud and has been sentenced to three 20-year terms in a federal penitentiary.

(5) Edwin Gray, Chairman FHLBB, admitted during congressional hearings in April 1984 that his agency might have been able to prevent Empire's failure if it had acted faster and more decisively. Gray added in the April 30, 1984, American Banker that the failure of Empire Savings was the result of "one of the most reckless and fraudulent land investment schemes ever encountered by the FHLBB.

(6) The Wall Street Journal on July 16, 1982, quoted Fernand St. Germain, Chairman, House Banking Committee, on the closing of Penn Square, ". . . hundreds of investors placed money in an institution which an agency of the U.S. Government knew to be unsound . . . public monies were used to examine the bank, collect data to analyze the condition, but the public didn't receive the results of the work for which they paid."

(7) Attorney General Edwin Meese III announced plans for a multi-agency attack on bank fraud, which he said had been a factor in more than half of the bank failures over recent years. Mr. Meese said that in 1984, there were 79 bank failures, and 27 failures of savings and loan institutions, a record number since the beginning of Federal controls in the 1930s. According to a Justice Department survey of 75 FDIC-insured banks that failed between 1980 and 1983, 61% involved "actual or probable criminal misconduct by bank insiders," he said.

(8) Edwin Gray in an appearance before a Senate Appropriations Subcommittee in March of 1985 said his examiners are grossly underpaid. Donald Hovde, FHLBB member, said "there is a high attrition rate among the Board's examiners. Twenty-five percent of our staff has less than two years' experience. In our Dallas office, 43% are trainees. We could use 130 examiners nationally tomorrow.

(9) Bank Board Chairman Gray has made repeated public appearances citing "horror stories" including thrifts and money brokers. However, former members of the Bank Board staff say the dozen or so "horror stories" represent an insignificant number when compared to the 3,500 thrifts in the country (and an even less significant amount when compared to the aggregate total deposits in the nations's thrifts).

Are then, the regulators' attacks on brokers and brokered deposits a smoke screen to hide their own ineptness or to mask even more serious problems in the banking system? Are brokered deposits the problem the regulators would like you to believe?

The case for brokered deposits:

(1) On September 28, 1984, House Report 98-1112, 98th Congress, 2nd Session, by the Committee on Government Operations published its findings in a 55-page booklet. Time permitting, we recommend to you reading it in its entirety. For the record, we will summarize here its findings:

"This analysis concludes that there is neither concrete evidence nor a coherent argument that insured deposit brokerage is inherently harmful to the banking system. Removal of the deposit insurance coverage for brokered deposits, as attempted by the agencies in their rule, cannot be justified by the evidence the agencies have presented, and it is also doubtful that capping every institution's holdings of brokered funds at some specific percent of deposits will have much effect.

There is clearly a problem in the deposit insurance system because of the subsidy it provides for high-risk lending strategies, and the insuring agencies have undeniably encountered cases of serious lending abuse funded with insured brokered funds. The arguments of the FDIC and FHLBB to justify removing effectively all deposit insurance coverage from brokered deposits break down, however, because of their failure to establish two key points. They have not established that the specific abuses cannot be controlled through normal supervision and, where warranted, criminal prosecution, and they have not established that eliminating insured deposit brokerage will stop the abuses.

In fact, there is persuasive evidence to the contrary on both points. On the first point, the Comptroller of the Currency has found it feasible to control the abuses among national banks within the existing regulatory framework and has consistently and publicly opposed the efforts of the FDIC and FHLBB to restrict the insurance coverage of brokered funds on the grounds that such a restriction is unnecessary. The FDIC and FHLBB have never satisfactorily explained why the normal supervisiory tools that are sufficient for the Comptroller are not sufficient for them also.

As to whether eliminating the insurance coverage for brokered funds will stop the abuses, or at least significantly hinder them, neither agency has made any attempt to demonstrate that institutions not employing brokered funds do not engage in similar abuses. Furthermore, on the basis of the agencies' own arguments about how banks and thrifts use brokered funds, the presumption would have to go the other way. Brokered funds are essentially used as a funding source for rapid growth by risk-oriented bank and thrift managers, and there is ample demonstration in the statistical materials presented in the preceding chapter that, among problem institutions, rapid growth without brokered funds is much more common than rapid growth with brokered funds. In other words, substitutes appear to be readily available for institutions that are denied access to brokered funds.

Finally, the committee rejects the agencies' notion that insured deposit brokerage is inherently an abuse of the insurance system that should be eliminated even if no abusive banking practices were associated with it. On the contrary, there are benefits to both depositors and sound financial institutions from the responsible practice of insured deposit brokerage.

For these reasons, the committee finds no justification for removing the deposit insurance coverage for brokered funds. Furthermore, for similar reasons, the committee also has reservations that putting a cap on the short-term insured brokered funds that institutions may hold at 15 percent of deposits may not contribute materially to relief from the abuses that have been associated with brokered funds.

The committee is concerned, finally, about the anticompetitive aspect of the agencies' efforts to eliminate insured deposit brokerage. The major stock brokerage firms' placements of their customers' funds into insured CDs, which account for a substantial percentage of the insured brokered funds in banks and thrifts, represents an innovative development in deposit gathering that contributes to the efficiency of the financial system. It also represents new competition, however, from outside the traditional boundaries of the banking and thrift industries. Therefore the agencies' effort to eliminate insured deposit brokerage, if successful, would have stifled this competition. Suppression of constructive innovation and competition is never good regulatory policy, and regulatory steps that have this effect should always be avoided unless other compelling factors make it necessary to override the competitive considerations. In the brokered funds situation, such compelling factors were not established by the agencies."

(2) On April 25, 1985, the House Committee on Commerce, Consumer and Monetary Affairs, concluded in a new report that it sees little evidence of abuse to support the FDIC claim that use of brokered deposits by commercial banks should be severely restrained.

While the FDIC announced that troubled banks used more than $9.3 billion of the $24.3 billion in brokered deposits in the banking industry, the subcommittee said this figure "has no relevance as an indicator of the size of the brokered funds problem". The subcommittee said that $8 billion of the more than $9 billion referred to by the FDIC was held by 13 or 14 large national banks "whose 'troubled' classification had nothing to do with their reliance on brokered funding." In addition, "most of this $8 billion in brokered funds was uninsured, anyway." (Even if we accept the FDIC figure of $9.3 billion as an accurate measure, this figure represents roughly .00465% of total deposits in the commercial banking system, hardly a significant amount.)

The subcommittee also found that brokered funding is less of a factor in bank failures than it had been previously. Failures of banks having 5 percent or more brokered funding declined from 56 percent of all failures in 1983 to 23 percent of all failures in the last half of 1984, the subcommittee said, and preliminary data for 1985 suggests the decline is still underway.

"For these reasons, there appears to be no current need for the kind of severely restrictive regulation or legislation on brokered funds that the FDIC proposed in 1984 and has continued to advocate in the current session of Congress," the subcommittee report claims.

Regarding use of brokered deposits by thrifts, information submitted by the FHLBB shows that brokered funds growth among problem institutions previously examined by the subcommittee completely stopped after March 31, 1984, and for all problem institutions rated 4 or 5 by March 31, declined at a 20 percent annual rate, even though brokered funds in nonproblem institutions grew at an 84 percent rate in the same time period.

The FHLBB March 26, 1984 imposed a temporary rule limiting the brokered funds growth of low net worth institutions.

"This appears to confirm the earlier judgment of the subcommittee that the regulators can control excessive brokered funding growth by problem institutions through supervisory means alone, without harsh new regulations or legislation," the subcommittee said.

However, the subcommittee also said the FHLBB has not effectively enforced its limit on acceptance of brokered funds by problem institutions. The subcommittee found that about 17 percent of problem thrifts were not in compliance with the rule during the second quarter of 1984, and about 21 percent were not in compliance in the third quarter.

"It therefore appears that even better supervisory control over brokered funds usage, at least among institutions with impaired net worth, can be obtained simply through consistent enforcement of the existing rule," the subcommittee said.

The FHLBB also failed to find "any fundamental systemic differences" in problem thrifts that relied upon brokered funds for their growth and those that did not, except in instances of linked financing arrangements, where funds obtained through brokers were directed toward specific, often risky, investments by a thrift, according to the subcommittee report. The agency also reported no evidence that thrifts using brokered funds paid more for their funding that comparably situated institutions paid for nonbrokered funds, the report says.

Finally, the subcommittee said that new net worth rules adopted by the FHLBB March 21, 1985, "will seriously limit the ability of institutions to continue the rapid growth policies they have followed in the past." The subcommittee said Congress should wait until it has a chance to assess the impact of these rules before considering legislation on brokered deposits.

On a separate issue, the subcommittee report also challenged the results of a research study conducted by the New York Federal Reserve Bank, which concluded that there is a need for a cap on brokered funds accepted by any individual institution. The subcommittee said the study "does not provide meaningful evidence to support a need for further brokered funds regulation or legislation."

(3) Sanford Rose, Editor of the American Banker, recently cited a study released by Cates Consulting of New York. In his column on February 26, 1985, Mr. Rose stated that, "Many would curtail or even ban the brokered deposit, which is said to have contributed to the failure of countless financial institutions. The palpable falsity of this proposition is demonstrated in a recently released study by Cates Consulting Analysts of New York. The study examines the reasons for failure at the 60 commercial banks

and some 16 savings and loans that folded between January 1 and September 30, 1984.* Particular attention is paid to the role of "brokered deposits in these 76 failures."

The study by Cates reveals:

"Of the 60 commercial banks that failed in the first nine months of last year, 37 (63%) had no brokered deposits whatsoever. Of the 23 that used brokered funds, nine employed them so sparingly that they could not have played any measurable part in the collapse of these institutions. The median ratio of brokered money to total deposits at these banks amounted to less than 7%.

"Six failed banks made moderate use of brokered funds -- 20% or less of total deposits. Only eight banks -- 13% of those that went belly-up during the period -- might well be described as immoderate gatherers of brokered funds, with usage amounting to more than 20% of total deposits. And only two of these eight banks were brokered funds hogs, taking more than 37% of their total deposits out of the brokered-funds market.

"There were 17 failures of savings and loans from January 1 to September 30 of last year. Data are available on 16 of these unfortunate institutions. Ten of the S&Ls had no brokered deposits at all. Of the six that used brokered funds, two got less than 2% of their total deposits from brokers, one obtained 19% of its money in this form, and in only three cases was the ratio of brokered to total deposits greater than 20%."

Mr. Rose has gone on to provide us with the following observations:

The most significant datum in the Cates study concerns the ratio of brokered funds to all forms of purchased money. The brokered deposit, whether retail or wholesale, bears some of the characteristics of purchased money. Brokers of retail funds generally aggregate retail deposits and place the funds in institutions in units of $100,000. Those who deal in wholesale funds perform the reverse operation, disaggregating larger chunks of money and also placing them in units of $100,000. Thus nearly all forms of brokered money appear on balance sheets in the category of large liabilities -- $100,000-and-over deposits.

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* There were 79 bank failures in 1984, the highest number since the Depression. These 79 banks represented approximately 1/2 of 1% of all commercial banks. These 79 banks had in the aggregate $2.9 billion in deposits representing less than .0002 of all deposits in commercial banks.

"As the Cates study points out, brokered funds represent only one category of large liabilities. Jumbo CDs, fed funds, repos, and commercial paper constitute the bulk of other types of purchased money.

"Observes Ray Garea, an executive vice president of the Cates Group and the author of the study: 'If we find that significant levels of brokered deposits were present in a substantial number of 1984 bank failures, that does not necessarily support a conclusion that brokered deposits cause or were even related to such failures. If the banks that failed made excessive use of other types of purchased money, it would be inappropriate to focus on brokered funds alone as a cause of failure. Attempting to limit or eliminate the use of brokered deposits would have little effect if banks could merely shift to other forms of purchased money.'

"A glance at the Cates data reveals that this is precisely what would happen. Surprisingly, failed banks that used brokered deposits have had abundant access to other bought money. The ratio of brokered deposits to bought money at the 23 failed banks that tapped the brokered-funds market was only 37%. In other words, the users of brokered money were able to obtain 63% of their purchased-money requirements from nonbrokered sources -- ostensibly from unwary investors in their local markets.

"Looked at from another vantage, the 23 failed banks with brokered deposits were excess users of bought money. They funded nearly 40% of earning assets with large liabilities. But only 13% of their assets were funded with the brokered-deposit component of bought money. The rest of the cash came from directly place paper. Thus the evidence would seem to indicate that, absent brokered funds, these banks could have gone elsewhere to finance their shaky portfolios.

"The same point can be made about the six failed S&Ls that made use of brokers. The ratio of brokered deposits to purchased funds at these institutions amounted to 48%. Clearly, thrift users of brokered money were able to obtain more than half of their total requirements from other sources.

"Where did these six as well as the other 10 failed thrifts get the purchased money that financed an excessive portion of their earning assets? That's easy. They got a large chunk of it from their respective Federal Home Loan Banks. Purchased funds at the 16 failed thrifts financed around 30% of earning assets. The proportion of earning assets funded by FHLB advances at these institutions averaged nearly 14%.

"Failed thrifts made considerably greater use of FHLB money than did healthier associations. The question might then be legitimately asked: If the regulators themselves provided the wherewithal for shaky associations to greatly expand their operations, how is it possible to single out for condemnation the deposit broker, who in some cases merely supplemented the effort of the governmental authorities?

"Or as analyst Ray Garea puts it more piquantly: 'If one wants to argue that a specific liability category causes S&L failures, then the solution is to dismantle the Federal Home Loan Bank System!'

"But the obvious fact is that specific liability categories are not responsible for the demise of thrifts or for that of commercial banks either. The 16 savings and loan casualties of 1984 perished because they assumed even more interest rate risk than did their peers. As a result, their net interest margins and their book capital positions deteriorated more rapidly than was the case at those associations which still cling to life.

"The 60 commercial banks that failed in 1984 did so because of problems of asset quality. In 1983, the median ratio of nonperforming loans to total loans at these 60 institutions was an astounding 11.44%. The ratio of chargeoffs to loans in 1983 was approximately 10 times greater in these banks than it was for banks in general. Even in 1982, 40% of the 1984 failures had loan losses equal to or greater than 1.46% of total loans." (Separately, an item in the American Banker, March 12, 1985, states that the FHLB propped up $110.6 million asset Western Community S&L with $106 million in loans during the 12 months preceding the closing of the thrift due to insolvency.)

(4) The Morgan Guarantee survey of January 1984 concludes: "The activities of money brokers are only a symptom of the underlying problem -- the encouragement of risk-taking provoked by the current system of deposit insurance. Even if brokered deposits were banned altogether, depository institutions could continue to obtain funds by other means, such as more widespread advertising. In fact, in the absence of money brokers, the establishment of a national newsletter to provide information to depositors on where they could obtain the highest rates would be a likely development. Depositors could then transfer funds in $100,000 increments to different depository institutions and continue to obtain federal deposit insurance for all these funds."

(5) Governor Gramley of the Federal Reserve, Mr. Wallison of the Treasury, former Comptroller of the Currency Conover and former FHLBB Chairman Pratt, cited various benefits to consumers, the financial institutions, and the economy from deposit brokerage.*

(6) On March 4, 1984, former Comptroller T. C. Conover was quoted in the Los Angeles Times: "While it is true that brokered funds may help problem banks grow quickly, it is important to remember that the problem is how the funds are used and not where they come from. Federal and state regulators have adequate authority and have had considerable success in dealing with the occasional mismanagement of assets by poorly managed institutions. I see no reason to believe that they will not be able to continue this performance in an era of brokered deposits."

(7) John Kareken and John Danforth, Sr., associates of Golembe Associates, Inc., a consulting firm, say: "Deposit brokers conserve on the resources devoted to deposit gathering and promote the movement of funds to their highest-value uses. If effective, uninsuring brokered deposits would thus be economically inefficient, and in addition would divert deposits away from small and medium-sized depository institutions and into the nation's largest. Moreover, it is extremely doubtful that adoption of the proposed new regulations would serve as an effective deterrent to institutions intent upon abusing the deposit insurance system."

(8) Former Senator Tower says that "Brokered CDs utilized by S&Ls have proven to be an important source of lending for residential housing." The Senator also said the funds were of "critical importance" to institutions trying to match assets and liabilities and trying to "respond efficiently" to the present deregulatory and competitive environment.

(9) And, finally, in his testimony on October 27, 1983, before a House Subcommittee, FDIC Chairman William Isaac said, "Many money brokers have performed responsibly. The benefits they have provided to both financial institutions and investors need only to be highlighted here. A financial institution that uses a broker's services to market its CDs can realize important cost savings through reduced staffing and paperwork requirement. Another advantage is that the institutions gains flexibility with respect to the amount and maturities of the CD it issues. This flexibility in turn can enable an institution to better match its assets and liabilities. Most important perhaps, is the access to national money markets that a broker can provide, particularly

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* Page 7, House of Representatives Report, 98-1112.

for small and medium-sized financial institutions. Money brokers also provide obvious benefits to investors."

By now, any open-minded reader of the foregoing, including the severest critic of deposit brokerage, must agree that: (1) brokered deposits provide a valuable and useful tool for investors and issuers alike; (2) bank mismanagement, including fraud and insider dealing is major cause for bank failures; and (3) a more alert, responsible regulatory effort can prevent most failures before they become major problems within the currently existing regulations.

We agree, however, that there remains legitimate concerns of the FHLBB and FDIC that must be addressed in appropriate legislation. These concerns were summed up by Chairman Gray of the FHLBB and reported on January 17, 1984, in the American Banker: "The issue we take up today on the appropriateness of an unregulated financial entity collecting funds, charging a sizeable fee, the placing of the funds without regard to the safety and soundness of a recipient depository institution and without regard to the potential consequences for the federal deposit insurance funds."

We, therefore, would like to have this Committee consider the following suggestions for inclusion in a bill on brokered deposits. We are confident that they realistically meet and even exceed the stated concerns of the regulators:

1. Register all brokers with the N.A.S.D. (for more than 50 years, the NASD has been an effective regulatory body with a long and distinguished history in the regulation of the securities industry).

2. Require all brokers of certificates of deposit to deal only with commercial banks and thrifts which meet or exceed regulatory minimum standards. (Brokers would be required to do a financial analysis of the institutions they perform a deposit brokerage service for, at least semi-annually. This analysis can be done "in-house" or purchased from one of several outside firms. Additional financial disclosure as called for by Chairman Isaac of the FDIC (but not endorsed by Chairman Gray) and more timely reporting would be helpful, but not completely necessary.

3. Require all deposit brokerage firms to report quarterly, to the appropriate agencies, the name of each institution for whom they provide service and the amount of dollars brokered during the preceding quarter.

4. Require all deposit broker firms to refrain from providing service to any institution which does not meet regulatory minimums without written permission from the appropriate agency. (This will meet those special circumstances such as American Savings where the regulators asked a group of firms to raise $1 billion in deposits.)

5. Brokers should be required to provide their client depositors with financial information on the financial strength and performance of the institutions receiving funds.

6. Institutions should be required to disclose information on their loan portfolios including a general description of the types of loans, percentage of loans in each area to indicate the institutions's position in an area and a disclosure on non-performing loans in each category.

Mr. Chairman, thank you for this opportunity to address the committee.

William A. Goldsmith
Executive Vice President
Professional Asset Securities, Inc.

Chairman **Hubbard**. Thank you for your time and for your presentation to our subcommittee today.

There are representatives here from both the Comptroller of the Currency Office and from the FDIC, and I trust Mr. Isaac and Mr. Selby will go over the remarks, as will Mr. Gray at the Federal Home Loan Bank Board.

We now call on Mr. Jorge Coloma, president of FAIC Securities, Inc., in Miami. Welcome to the subcommittee. We await your testimony. Your remarks will be included in the record.

STATEMENT OF JORGE H. COLOMA, PRESIDENT, FAIC SECURITIES, INC., MIAMI, FL

Mr. **Coloma**. Thank you.

Mr. Chairman and Mr. Parris, I want to express my appreciation to both of you for your patience in waiting so long just to hear my views on the situation. My name is Jorge Coloma, I am president of FAIC Securities, Inc. I appreciate the opportunity to express my views on an issue of critical concern not only to our company but to the economic well being of the thousands of smaller thrifts, independent banks, and credit unions that use brokered deposits. Last year, the FDIC and the Federal Home Loan Bank Board proposed severe restrictions on the insurance of brokered deposits placed in federally insured banks and thrift institutions.

In March 1984, in connection with the proposed regulations by the regulators we testified before the subcommittee of the House Committee on Government Operations about how the regulators could respond to their concerns that insured deposit brokerage might contribute to the thrift crisis and expose the insurance funds to added risks. The regulations proposed at that time by the FDIC and FHLBB to limit insured deposit brokerage threatened the very existence of the brokered deposits industry, not to mention the financial institutions who use this service to the benefit of their local communities.

At that time, we offered less onerous regulatory alternatives to meet the concerns of the regulators. For example, we urged the regulators to regulate deposit growth by requiring an increase in deposits to be matched by a proportionate increase in capital and to require the deposit brokerage industry itself to report to the regulators about funds placement.

Nonetheless, despite unprecedented opposition from the large majority of nearly 7,000 commentators, including members of both Houses of Congress, other Federal financial industry regulators and the Department of Justice, the FDIC and FHLBB went forward without substantial revision with a final version of the regulations on March 26, 1984.

Accordingly, FAIC had no alternative but to initiate a lawsuit in Federal court that very afternoon to halt what we felt was an unlawful action and not within the intention of Congress. A few weeks later the Securities Industry Association, who represents most of the giants of the industry, saw fit to join our lawsuit. In June, 3 months after we first filed the lawsuit, the Federal District Court for the District of Columbia held that the regulators' initial actions were unlawful.

The regulators, faced with this ruling from the Federal court, appealed to a higher court, but meantime adopted regulations that accomplished many of their stated and worthwhile objectives. This more logical move on the part of the regulators was due in large part, I am pleased to say, to the congressional efforts to restrain the regulators by the introduction of numerous bills, hearings, letters of concern and so forth.

What they have done so far is the following:

Limited the exponential growth of depository institutions by requiring that growth in deposits be linked to graduated increases in net worth.

Reduced the risk of direct new investments by thrift institutions.

Required periodic reports by depository institutions to the regulators about their brokered deposits, and capped the use by a depository institution of brokered deposits to 5 percent of its total assets if the institution's net worth falls below 3 percent of its liabilities.

Increased deposit insurance premiums or proposed basing them on risk.

These less onerous alternatives were prudent and rational responses to what are the regulators' real concerns—the safety and soundness of depository institutions and the solvency of the respective insurance funds. Most knowledgeable parties are learning that the deposit brokerage industry is not the source of the multitude of problems that seem to threaten to overwhelm the regulators. As the regulators themselves have admitted, the perceived risks to their respective insurance funds are the handiwork of incompetent or unscrupulous * * * managers who gambled away * * * insured deposits on high risk investments or outright fraud.

Insured deposit brokerage provides investors, depository institutions, and the overall economy many benefits. They include:

Enabling small and medium sized depository institutions to compete with the largest banks and savings and loan institutions throughout the country.

Providing liquidity to individuals and institutions.

Permitting depository institutions to obtain deposits at interest rates and maturities that will better match the characteristics of their loans.

Enabling depository institutions to effectively compete for funds with other entities with respect to institutional short term deposits.

I wish to make an additional point. We do not believe short-term brokered deposits maturing in a year or less are inherently more dangerous than long-term brokered funds. The FDIC and the FHLBB have both supported this approach. In a joint statement they said, an account with a longer maturity does not carry the imminent threat of a nonrenewal but is nonetheless subject to the same reinvestment problems as a short-term account.

Indeed, last year the FHLBB admitted, in response to questions posed by the Department of the Treasury that no information on broker originated deposits by maturity is currently available.

The FDIC last year also in response to a question by the Subcommittee on Commerce, Consumers and Monetary Affairs of the House Government Operations Committee stated that data on maturities of brokered deposits is not available. Maturities, however, are typically a function of cost at the moment and the use to which the institution wishes to put the funds. These short-term brokered funds help institutions to better manage their maturities, provide a source of necessary liquidity, that they will not otherwise find available. The effective cost of such funds is often cheaper than the cost of attracting short term deposits through brick and mortar facilities or alternative sources from major brokerage houses.

However, to safeguard against any possible concern, I have recommended to the FDIC that a congressional solution should include language that provides that no insured depository institution accept additional insured brokered deposits from such deposit broker if more than 25 percent of the institution's insured brokered deposits mature in more than any 3 month period.

Let me return briefly to the Federal court action. The regulators, as I have said earlier, saw fit to appeal the Federal district court's decision declaring the regulations illegal. In January 1985, more than 6 months after the lower court decision, a three judge panel of the U.S. Court of Appeals for the District of Columbia affirmed the lower court decision which had validated the proposed regulations. By ruling that insured deposits placed through deposits placed through deposit brokers receive full Federal deposit insurance, the court of appeals, as a result of FAIC's concerted efforts and the belated help of the Securities Industry Association, placed its approval on a nationwide system of insured deposit brokerage.

The story doesn't end there. Since the proposed regulations were first published, FAIC has suffered an erosion of customers who have chosen not to place deposits through FAIC, given the climate created and nurtured by the regulators. Despite two court decisions unfavorable to the regulators' position and attitude, these same regulators are expected within a few weeks to make a formal request for a judicial review of the previous decisions. The regulators have not rescinded the regulations and one regulator has sent out what I consider a menacing signal indicating that the agency still intends to consider other methods of fulfilling its mandate with regard to the use of brokered deposits by all institutions.

This does not encourage our customers to continue to do business with us. It is unfair. It is unjust, and certainly improper when two Federal courts have already given the matter their undivided attention.

So, despite all our efforts, the regulatory atmosphere is still contentious. With the judicial branch of government against them they are fighting back with public speeches and press releases.

Recently, in a new assault on brokered deposits, the FDICIC identified banks, thrift institutions, and credit unions that had placed funds through deposit brokers in two banks that failed, suggesting a cause and effect connection. It is a clear attempt to embarrass and intimidate deposit brokerage customers.

We also continually hear from depository institutions that they are being pressured strongly by Federal examiners on their brokered deposits, whether they are investors or receivers of brokered funds. The effect has been to put our customers in a difficult position and endanger important and crucial business relationships.

In light of these events FAIC believes it must try to find a means to a reconcilation between the regulators and the deposit brokerage industry. In a spirit of cooperation, FAIC in recent months has met with FDIC Chairman Isaac, FDIC staff, FHLBB staff, the Congress, and other members of the deposit brokerage industry in an attempt to fashion a congressional solution that would respond to the residue of the regulators' and deposit brokers' concerns and restore a more rational business climate.

On June 5, 1985, in testimony before the Subcommittee on Financial Institutions and Consumer Affairs of the Senate Committee on Banking, Housing, and Urban Affairs on deposit brokerage regulation legislation, we proposed what I believed to be a reasonable and logical compromise that all the parties might be able to live with, although with some sacrifices. However, since that time, we have indicated a willingness to bend even further to reach a congressional solution. The proposal I am making today would:

Provide a cap of 15 percent of deposits on insured brokered short-term deposits and a cap of 20 percent of deposits on insured brokered long-term deposits or a pro rata combination thereof at a depository institution when it meets its minimum net worth requirements, as determined by the regulators.

Place a prohibition on any insured brokered deposits at a depository institution when it fails to meet is minimum net worth requirements, as determined by the regulators.

Restrict a depository institution from having more than 25 percent of its maximum allowed insured brokered deposits maturing in any one 3 month period.

Require deposit brokers to report to the Federal regulators key information about brokered deposits.

Retain the regulators' extensive authority to regulate other potential abuses of the free market system of funds placement.

FAIC has encouraged the regulators, other deposit brokers and the Congress to help develop a congressional solution to this troublesome issue. I am pleased to see that Chairman Isaac, in his testimony today, indicated that he can accept a bill as long as the cap is reasonable and so long as the law does not in any way impinge on the regulators' current authority to prohibit the use of any brokered funds by any troubled institutions.

I believe we can find a congressional solution that the regulators would not object to. Mr. Chairman, I urge you and the members of the subcommittee to consider this effort as a solution and help convince the regulators to work toward a speedy, balanced and fair congressional solution of the remaining issues that could be acceptable to all the major parties concerned.

In conclusion, I believe the program I have outlined here reflects a more practical, up to date view of the needs of the regulators and is one that the entire deposit brokerage industry and the Congress might find acceptable. It could end the turmoil of the last 18 months, help restore a more normal business atmosphere to the deposit brokerage industry, and resolve the remaining concerns of the regulators.

I appreciate the opportunity to appear before the subcommittee and would be pleased to answer any questions and provide further information as requested.

[The prepared statement of Mr. Coloma on behalf of FAIC Securities, Inc., follows:]

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TESTIMONY
OF
JORGE M. COLOMA

PRESIDENT,
FAIC SECURITIES, INC.
MIAMI, FLORIDA

BEFORE THE
SUBCOMMITTEE ON GENERAL OVERSIGHT AND INVESTIGATIONS
OF THE
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
ON
DEPOSIT BROKERAGE REGULATION LEGISLATION

July 16, 1985

Mr. Chairman and members of the Subcommittee, my name is Jorge Coloma. I am President of FAIC Securities, Inc. */ ("FAIC"), which is located in Miami, Florida. I appreciate the opportunity to express my views on an issue of critical concern not only to our company, the largest institutional certficate of deposit broker in the nation, but to the economic well-being of the country's smaller thrifts, independent banks and credit unions that use insured brokered deposits.

As you are well aware, last year the Federal Deposit Insurance Corporation ("FDIC") and the Federal Home Loan Bank Board ("FHLBB") proposed severe restrictions on the insurance of brokered deposits placed in Federally-insured banks and thrift institutions.

In March, 1984, in connection with the proposed regulations by

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*/ FAIC Securities, Inc. is the largest institutional certificate of deposit broker in the United States. FAIC is registered as a broker-dealer under the Securities Exchange Act of 1934 and is a member of the National Association of Securities Dealers, Inc. Established in mid-1980, FAIC today places over $600 million in certificates of deposits each month. FAIC has one of the largest trading rooms in the Southeast and employs over 100 persons. FAIC has placed over $9 billion in certificates of deposit with more than 700 Federally-insured depository institutions, mostly small and medium-sized commercial banks and savings and loan associations. FAIC has more than 4,000 institutional and individual investors. These depositors include financial institutions (including credit unions), pension funds, local, State and Federal governmental entities, school districts, Indian tribes, religious organizations and hospitals. FAIC's offices are located at 2600 S.W. 3rd Avenue, Miami, Florida, 33129; and its telephone number is (305) 858-2519.

the FDIC and the FHLBB, we testified before a Subcommittee of the House Committee on Government Operations about how the regulators could respond to their concerns that insured deposit brokerage might contribute to the thrift crisis and expose the insurance funds to added risks. The regulations proposed at that time by the FDIC and FHLBB to limit insured deposit brokerage threatened the existence of the deposit brokerage industry not to mention their impact on the smaller financial institutions who use this service to the benefit of their local communities. At that time, we offered less onerous regulatory alternatives to meet the concerns of the regulators. For example, we urged the regulators to regulate deposit growth by requiring an increase in deposits to be matched by a proportionate increase in capital and to require the deposit brokerage industry itself to report to the regulators about funds placement.

Nonetheless, despite unprecedented opposition from the large majority of nearly seven thousand commentators, including members of both Houses of Congress, other Federal financial industry regulators and the Department of Justice, the FDIC and FHLBB went forward without substantial revision with a final version of the regulations on March 26, 1984. FAIC believes there was no rational basis for the regulators' conclusion that a limitation of Federal insurance coverage for brokered deposits would be reasonably responsive to their concerns about the safety and soundness of depository institutions and the insurance funds.

Accordingly, FAIC had no alternative but to reluctantly initiate a lawsuit in Federal Court to halt the unlawful action of the regulators. In June, 1984, Judge Gerhard Gesell of the Federal District Court for the District of Columbia held that the regulators' action to impose a $100,000 limitation on insuring brokered deposits for all funds placed by any one deposit broker in a single depository institution was unlawful; set aside the regulations; and enjoined their implementation.

On September 28, 1984, the House Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations issued a report on Federal Regulation of Brokered Deposits In Problem Banks and Savings Institutions, which stated that:

> ... agency rules or legislation to restrict the insurance coverage just of brokered deposits, or to place a cap specifically on the brokered funds holdings of banks and thrifts, will not deal effectively with the problem of excessively rapid growth and risky lending by problem institutions.

The report recommended several reasonable alternatives: strengthening supervisory control over problem institutions; increasing capital standards; increasing public reporting of brokered deposits; and reducing incentives for depository institutions to take excessive risks with their investments. These alternatives reflected many of the comments submitted to the regulators on their proposed regulations and were consistent with the alternatives recommended in FAIC's testimony.

The regulators eventually accomplished many of their necessary objectives by other, more practical alternatives. They have, in fact:

- limited the exponential growth of depository institutions by requiring that growth in deposits be linked to concommitant, graduated increases in net worth;
- reduced the risk of direct new investments by thrift institutions by limiting them to 10 percent of liabilities or twice net worth -- larger investments would require securing prior approval from the regulators;
- required periodic reports by depository institutions to the regulators about their brokered deposits;
- proposed other increases in capital requirements;
- capped the acquisition by a depository institution of brokered deposits to 5 percent of its total assets if the institution's net worth falls below 3 percent of its liabilities; and

- increased deposit insurance premiums or proposed basing them on risk.

The adoption of these less onerous alternatives was due in large part to Congressional efforts to restrain the actions of the regulators as expressed through numerous introduced bills, hearings, letters of concern, studies and much appreciated hard work.

These less onerous alternatives were prudent and rational responses to what are the regulators' necessary concerns -- the safety and soundness of depository institutions and the solvency of the respective insurance funds. Most knowledgeable parties are learning that the deposit brokerage industry is not the source of the multitude of problems that seem to threaten to overwhelm the regulators. As the regulators themselves have admitted, the perceived risks to their respective insurance funds are "the handiwork of incompetent or unscrupulous ... managers who have gambled away ... insured deposits on high-risk investments or outright fraud."

Insured deposit brokerage provides investors, depository institutions, and the overall economy many benefits. They include:

- permitting individuals and small investors to obtain the most attractive interest rates and range of maturities wherever in the country they may be offered;
- permitting individuals and small investors to have the benefit of the attractive rates available for larger denomination deposit instruments;
- enabling small and medium-sized depository institutions to compete for funds with the largest banks and savings and loan associations, thereby facilitating the movement of funds from capital-surplus to capital-deficit areas;
- providing liquidity to individuals and institutions by facilitating the purchase and sale of deposit instruments, especially short-term deposit instruments in secondary markets;
- permitting depository institutions to obtain deposits at interest rates and maturities that will better match the characteristics of their loans;
- enabling depository institutions to effectively compete for funds with other entities, such as money market funds, thereby increasing the financial safety and soundness of those depository institutions;
- increasing funds available for housing loans by attracting new funds to depository institutions; and

- reducing the institutional costs for depository institutions of establishing and maintaining accounts.

In January of 1985, a three-judge panel of the U.S. Court of Appeals for the District of Columbia affirmed the District Court decision invalidating the proposed regulations. By ruling that insured deposits placed through deposit brokers receive full Federal deposit insurance, the Court of Appeals, as a result of FAIC's concerted efforts, placed its formal stamp of approval on a nationwide system of insured deposit brokerage for institutions and individuals.

On April 25, 1985, the House Subcommittee on Commerce, Consumer and Monetary Affairs of the House Government Operations Committee issued a new report on brokered deposits entitled New Findings on Brokered Deposits. It concluded that:

> ... there appears to be no current need for the kind of severely restrictive regulation or restriction on brokered funds that the FDIC proposed in 1984 and has continued to advocate in the current session of Congress.

We agree. However, the report did not focus on the problems we as businessmen are confronted with in this area.

Since the proposed regulations were published, FAIC has suffered erosion of customers who have chosen not to place deposits through FAIC given the attitude of the regulators.

Despite two court decisions unfavorable to the regulators' position, within a few weeks the regulators are expected to make a formal request for a judicial review of the previous decisions by the entire U.S. Court of Appeals for the District of Columbia. The regulators have not rescinded their regulations, and one regulator has sent out a signal that it still intends to "... consider other methods of fulfilling its mandate with regard to the use of brokered deposits by all institutions." Despite all our efforts, the regulatory atmosphere is still contentious as the regulators have continued to make speeches and issue press releases about the dangers of insured brokered deposits. Recently, in a new assault on brokered deposits, the FDIC identified banks, thrift institutions and credit unions that had placed funds through deposit brokers in two banks that failed. It was a clear attempt to embarrass and intimidate deposit brokerage customers. The FDIC also announced last month that troubled banks hold more than $9 billion of the $24 billion in brokered deposits in the banking industry. In addition, in connection with a recent bank failure in Wisconsin, the FDIC indicated that, in part because of brokers, it now intends to cease full payouts of insured brokered deposits in possible cases of fraud. This attempt at market discipline has caused confusion in the marketplace and effectively undermined the system of insured deposit brokerage. We also continually hear from depository institutions that they are being pressured strongly by Federal examiners on their brokered deposits, whether they are investors or receivers of brokered funds. The effect has been to put our customers in a difficult position and endanger important and crucial business relationships.

In light of these events, FAIC believes it must try to find a means to a reconciliation between the regulators and the deposit brokerage industry. In a spirit of cooperation, FAIC in recent months has met with FDIC Chairman Isaac, FDIC staff, FHLBB staff, the Congress, and other members of the deposit brokerage industry in an attempt to fashion a legislative solution that would respond to the residue of the regulators' and deposit brokers' concerns and restore a more rational business climate.

On June 5, 1985, in testimony before the Subcommittee on Financial Institutions and Consumer Affairs of the Senate Committee on Banking, Housing and Urban Affairs on deposit brokerage regulation legislation, we proposed what I believed to be a reasonable and logical compromise that all the parties might be able to live with, although with some sacrifices. However, since that time we have indicated a willingness to bend even further to reach legislative resolution. The proposal I am making today would:

- provide a cap of 15 percent of deposits on insured brokered short-term deposits and a cap of 20 percent of deposits on insured brokered long-term deposits or a pro rata combination thereof at a depository institution when it meets its minimum net worth requirements, as determined by the regulators;
- place a prohibition on any insured brokered deposits at a depository institution when it fails to meet its minimum net worth requirements, as determined by the regulators;
- restrict a depository institution from having more than 25 percent of its maximum allowed insured brokered deposits maturing in any one three-month period;
- require deposit brokers to report to the Federal regulators key information about brokered deposits that will help the regulators anticipate and limit potential imprudent uses of those funds by the management of insured depository institutions; and
- retain the regulators' extensive authority to regulate other potential abuses of the free market system of funds placement, but prohibits discrimination against insured brokered deposits.

FAIC has encouraged the regulators, other deposit brokers and the Congress to help develop a legislative solution to this troublesome issue.

Mr. Chairman, I urge you and the members of the Subcommittee to consider this effort at a solution and help convince the regulators to work towards a speedy, balanced and fair legislative resolution of the remaining issues that could be acceptable to all the major parties concerned about this issue.

I recommend this approach to you for several reasons.

It will restore a normal business climate to the deposit brokerage industry.

More importantly, it recognizes the remaining concerns of the regulators.

It treats all deposit brokers on an even-handed basis.

In conclusion, I believe the proposal I have outlined here reflects a more practical, up-to-date view of the needs of the regulators and is one that the entire deposit brokerage industry and the Congress might find acceptable.
FAIC appreciates the opportunity to appear before the Subcommittee and would be pleased to answer any questions and provide further information as requested.

Chairman **Hubbard**. Thank you, Mr. Coloma.

Using the 5-minute rule again, Mr. Goldsmith, what is the percentage of short-term and long-term brokered deposits in your business?

Mr. **Goldsmith**. I would say that the average maturity of all CD's is approximately 180 days. Now, it has often been said that short-term money is hot money.

My years of experience in the business have indicated that this is absolutely not true. Our average maturity of 180 days will roll three or four times before that money is withdrawn.

It is merely a function of the marketplace and of the institution who is making that deposit's need for asset liability management. Denying this flexiblity in this area of intense competition would certainly increase costs to all concerned.

Chairman **Hubbard**. Do you believe institutional investors should be eligible for FSLIC and FDIC insurance?

Mr. **Goldsmith**. I believe FSLIC and FDIC insurance is too high at $100,000. Mr. Falzon's testimony stated that approximately the average deposit of his clients was about $14,000. If my facts are correct, the average deposit of the average consumer in the United States is less than $20,000.

If we had the same information, we, the broker, had the same financial information available to the regulators, we could do a better job of regulating and bringing market discipline to the market than they have done and we wouldn't need $100,000 insurance.

If the law as they claim was intended for the individual, then lower the insurance back to $20,000. We are doing pretty good with the limited information we have now. Give us more information and we will do a better job.

Chairman **Hubbard**. During the testimony of the panel just prior to yours, panel two, and I notice Ray Thomas and Dick Reibman are still here—we heard that Merrill Lynch and Dean Witter support H.R. 107 as cosponsored by Congressmen Barnard, Schumer, and Garcia.

They say this is legislation that will resolve the brokered deposits issue. On page 14 of your testimony, Bill Goldsmith, you said you support the following, and I heard you say, No. 1, registering all brokers with the NASD; second, requiring all brokers of CD's to deal only with commercial banks and thrifts that may exceed regulatory minimum standards.

You said you would support requiring all deposit brokerage firms to report quarterly and you had other recommendations. Why are your recommendations that much different from the previous witnesses?

Mr. **Goldsmith**. If I believe that the cap of 15 percent on brokered deposits was a solution, then I would believe that brokered deposits were inherently wrong and I would be out of this business. I believe if you capitulate to that type of thinking, then you are agreeing with the regulators that the brokered deposits are harmful and I have come to the conclusion, and I have been in this business probably a lot longer than Mr. Falzon, a little bit longer than Mr. Coloma, and I am not sure how much longer than the gentleman from Dean Witter, but a total of about 15 years, and all the evidence that I can find clearly indicates that the source of liabilities is not the problem, it is what the institutions are doing with it.

Now, I have heard the regulators say that they can't do anything about what the institutions are doing with this money and I find that hard to believe. If they can't control what the institution does with its money, then how is a broker supposed to control it.

Chairman HUBBARD. For the record, your answers—why can't you support limits on an institution's ability to accept short-term brokered deposits of 15 percent of its total deposits and other provisions of this particular bill, H.R. 107?

Mr. GOLDSMITH. There is available today a sophisticated—in fact several sophisticated asset liability management software packages that can be used and employed—one currently being used by four Federal Home Loan District banks called duration analysis. By using that a bank or thrift can accept short- or long-term deposits and, frankly can make with little risk long-term loans with short-term deposits by using duration analysis techniques.

I find that by restricting an institution's use to 15 percent on short-term, you restrict their flexibility to practice sophisticated asset liability management techniques.

Chairman HUBBARD. My time is up. I do have three questions for Mr. Coloma.

I will call on Congressman Parris.

Mr. PARRIS. Thank you, Mr. Chairman.

I will be very brief. I have another meeting at 2 o'clock.

Mr. Goldsmith, would most of your colleagues in the brokerage business agree with your suggestions that you outline in your testimony here today?

Mr. GOLDSMITH. I think if they were as smart as I am they would.

Mr. PARRIS. Do you think they are?

Mr. GOLDSMITH. If they were from Virginia they might.

Mr. PARRIS. Do you think the industry would generally support those recommendations?

Mr. GOLDSMITH. I gather from the testimony from—that I heard from panel two this morning that the rules that they are asking or the legislation that they are asking for serves their needs and not anyone else's. As I said before, if it is good for Merrill Lynch, it must be good for the United States, and I don't agree with that.

I used to work for Merrill Lynch.

Mr. PARRIS. The recommendations are very similar to those outlined by Mr. Coloma in his recommendations, list of suggestions of legislative inclusion. That is generally true, isn't it, Mr. Coloma, they largely track together the proposals that you outline?

Mr. COLOMA. Except that H.R. 107 has a limitation of $100,000 of insurance.

Mr. PARRIS. In terms of percentages and reasonable standards and all that other business, they are generally similar, aren't they?

Mr. COLOMA. Well, they make a distinction between long-term and short-term deposits which we do not make, nor does the Bank Board or the FDIC.

It limits to $100,000 the insurance claim of any one depositor, which puts roughly 30,000 small financial institutions throughout the country out of the CD market.

Mr. PARRIS. I guess the real points of departure as Mr. Isaac testified this morning that short-term and long-term doesn't matter, brokered deposits are the same thing and he thinks they ought to be dealt with alike and you disagree?

Mr. COLOMA. I agree on what you just said, yes.

Mr. PARRIS. That they should be dealt with in a similar fashion?

Mr. COLOMA. Yes.

Mr. GOLDSMITH. In answer to your question about others agreeing with me, I think back in the late 1400's there was a gentleman who disagreed with about everybody else in the world that the world was round instead of flat. I still believe that the world is round and if my colleagues believe that it is flat, I can prove them wrong.

Mr. PARRIS. One other quick question.

I am interested in the fees. I haven't the vaguest notion. Can you give me a round number?

I am sure this is not a nonprofit exercise.

Mr. GOLDSMITH. I can give you a precise number. The fee or the spread, if you will, amounts to 25 basis points or one-quarter of 1 percent annualized so it depends obviously the longer the deposit, the more you earn for the fee, for a specific deposit.

Mr. PARRIS. So if I were, and this may not be typical of brokered deposits, but if I were a local individual and had $100,000 cash and my local S&L was paying 7.5 percent on money market funds, and the Beverly Hills S&L was paying 7.4, it would be a wash. If they are paying above 7.4, I am going to make money by giving you my money to invest with them.

Mr. GOLDSMITH. This is what is happening. Several Virginia clients of ours, depositors, can attract money through their local branch system today at fairly low rates because there doesn't seem to be a lot of activity, lending activity. So they take this money from their branch system, and they reinvest it in the liabilities of other institutions who have greater activity, and pick up a little arbitrage, a little spread, until they themselves can find loans that meet their parameters.

So it serves a function for the small and middle sized institution.

Mr. PARRIS. Well, we have the same situation in a macro scale in terms of the investment of a great degree of the capital assets of some of the largest institutions of this Nation in international lending.

I hope you are dong better by them than some of them have done by themselves in terms of the international market at least as to the credit worthiness of the extension of the credit.

Mr. GOLDSMITH. There has been a great deal said this morning about risk of assets. When First Chicago, for example, made loans to International Harvester, was that a risk asset? It turned out to be.

When—there are a lot of horror stories. Mr. Isaac is fond of telling a few typical horror stories to try to prove a point for an entire generation of institutions.

It doesn't seem to work. When the loan to International Harvester was made, it was a good loan.

Mr. PARRIS. Hindsight is wonderful.

Mr. GOLDSMITH. When the loans to Mexico were made, they were good loans.

Mr. PARRIS. Sovereigns don't default; right?

Mr. GOLDSMITH. I have heard that.

Mr. PARRIS. That is wrong.

Thank you very much, gentlemen. I appreciate your being here.

Mr. GOLDSMITH. Thank you for staying so long and missing lunch.

Chairman HUBBARD. Thank you, Congressman Parris, for your helpfulness during today's hearings.

What is the percentage of short-term and long-term brokered deposits in your business, Mr. Coloma?

Mr. COLOMA. If you define short-term brokered deposits as a deposit of maturity of a year or less, 80 percent of our business is short term and 25 percent being long term, of maturity of more than a year.

Chairman HUBBARD. Why should institutional investors be eligible for FDIC and FSLIC insurance, in your opinion?

Mr. COLOMA. I don't see why we should make a distinction between a financial institution and a municipality that has some money to invest or a school district or a corporation that has some access funds to invest for a particular period of time.

Financial institutions have to by regulation maintain a certain portion of their assets invested in short-term money market instruments for liquidity purposes. One of the instruments that they invest in is CD's of other financial institutions.

If they didn't have insurance, then they would be limited to investing in the CD's of large commercial banks and commercial papers of corporations that to my thinking carry a much higher risk of default than the CD's that we sell them.

Chairman HUBBARD. You are aware that the regulators disagree with your comments and of course some Members of Congress do also?

Mr. COLOMA. Yes. It has just been in the past week that Chairman Isaac has come with a proposal to strip away the insurance from other financial institutions and I certainly disagree with that.

Mr. GOLDSMITH. There seems to be an assumption on the part of Congress and others that the small and medium sized banks or credit unions or thrifts possess a degree of sophistication that would allow them to analyze the financials of the institutions in which they are placing their deposits and nothing could be further from the truth.

These medium-sized institutions who use brokers do so largely because they either don't have the time, and certainly many, if not most, of them lack the sophistication to do the kind of analysis that we do.

Mr. COLOMA. I would like to add one more thing before we finish on this subject.

The regulators are proposing to strip away the insurance from other financial institutions. If you are trying to control the growth of insured broker deposits, I don't think it would have any effect at all.

You would take away the insurance from these financial institutions who deposit their funds in other financial institutions through brokers, but turn the brokers around and have them concentrate their efforts in looking for depositors that would be corporations, municipalities, school district or high net worth individuals and the market will just develop on a different side and you still have the same problem, so I don't think that that would be a solution to the problem that we have.

Chairman HUBBARD. One last question to Mr. Coloma.

Jorge, during your June 5, 1985, testimony before the Senate Banking Committee, you listed your recommendations to resolve the issue of brokered deposits that are basically the same as listed in your prepared statement of today, shown on page 10.

There is one notable exception, and that is your point number one. Why is FAIC or your corporation now ready to distinguish between short- and long-term deposits, and indeed, now ready to accept caps of 15 percent for short term and 20 percent caps for long term?

Mr. COLOMA. I am trying to be practical. Under the current environment that we have, it is extremely difficult to function. Even though the regulators do not make a distinction between short- and long-term deposits, our competitors on Wall Street have made it a point to make a distinction.

In order to reach an accommodation, both Chairman Isaac and ourselves have agreed to negotiate some sort of cap on brokered deposits, and I, as a gesture of accommodation, have suggested to cap short-term brokered deposits at a lesser level than long-term brokered deposits, but just to accommodate the other major participants in the market.

Chairman HUBBARD. One last question for Bill Goldsmith to follow up on a comment you made a few minutes ago. Do you think the short-term money will flee a bank once it has learned that the bank has become a troubled bank?

Mr. GOLDSMITH. Let me answer that two ways, if I may. First, to answer your question directly, I think that once a depositor has become aware that the institution is troubled that both short- and long-term deposits would leave regardless of a withdrawal penalty. I also take exception to the—well, maybe take exception is too harsh.

I also find it difficult to believe that neither Merrill Lynch nor Dean Witter would agree to repurchase or continue to make a secondary market in these long-term deposits that they favor if an institution has failed.

This is my assumption, that they would just tell their clients that the institution has failed and there is no longer a secondary market.

Chairman HUBBARD. Thank you very much, Bill Goldsmith, to you and Jorge Coloma, and the other witnesses who testified today, this subcommittee would welcome your additional comments.

I have a feeling that Ray Thomas and Dick Reibman would love to come back to the table and make some more statements.

Mr. **Goldsmith**. One last statement. If an institution knew that it would be on a troubled list and that troubled list would be published, we would have fewer troubled institutions. I think the managers of those institutions would act more prudently.

Chairman **Hubbard**. Thank you.

I would like to say a word of appreciation to William Chasey, president of the William Chasey Organization, on the front row all day during the hearing, who has been very helpful to the subcommittee regarding the hearing today.

Thank you for your interest in today's brokered deposits hearing. One more time, to all the witnesses we say thanks, those from Washington, those from New York and for sure who would come all the way from Del Mar, CA, and to one who would leave Miami, FL, during the Miss Universe pageant and leave the beauties behind and come to Washington—a special thanks to you, Jorge Coloma.

To the staff who made the hearing possible—the reporters, Marcia Stein, and Ray Boyum, who have been helpful to us in preparing the record of this hearing, to Mary Martha Fortney, our staff director, to Byron Anderson, the minority staff director, Greg Carter, our counsel, Pam Satterwhite, our clerk, and the other members of the staff—thank you for your courtesy and helpfulness.

We now stand adjourned. Thank you.

[Whereupon, at 2:20 p.m., the subcommittee adjourned subject to the call of the Chair.]

(The following material was referred to on page 41 and submitted for the record by Mr. Selby)

EC - 221

EXAMINING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type		Subject	
	Examining Circular		Brokered Deposits

To: Deputy Comptrollers; District Administrators;
Division Directors; and Examining Personnel

Summary

Examining personnel should give close attention to the potential for abuses in the use of brokered deposits and comment in the report of examination on their effect on the bank's condition and the bank's ability to replace them as a source of funds.

Purpose

This circular reaffirms OCC's supervisory policy relative to the use of brokered deposits by national banks. The policy is intended to provide general guidance and permit flexibility in determining an appropriate supervisory response for banks using money brokers as a significant source of funds.

Background

On March 26, 1984, the FDIC adopted a rule that will effectively eliminate federal insurance on deposits directed to depository institutions by money brokers. Generally, brokered deposits placed or renewed on or after October 1, 1984 will be limited to $100,000 per broker per insured institution. All deposits made prior to October 1, 1984 will continue to be insured until their maturity dates. Deposits with no fixed maturities such as money market deposit accounts placed by deposit brokers prior to October 1, 1984 will be insured until November 30, 1984, but thereafter are subject to the rule. Brokered deposits held on March 26, 1984 (date of rule adoption) may be renewed one or more times by the depositor until October 1, 1986 and will continue to qualify for deposit insurance subject to certain conditions specified in the rule.

In view of the delayed effective date of this final rule, OCC is concerned that some banks may substantially increase their volume of brokered deposits prior to October 1, 1994 and subsequently use those funds in an unsafe and unsound manner.

Additionally, the OCC is concerned about the ability of banks that are significantly relying on brokered deposits to replace them as a source of funds. It is anticipated that the FDIC's new rule will substantially reduce the brokered funds market, especially the retail (individual customers) and the smaller denomination institutional (less than $100,000) sectors of the market. Banks with large amounts of these funds will need to develop plans to handle a run-off of these deposits should they not be renewed at maturity.

Procedure

Examining personnel should give close attention to those institutions that derive a material amount of their deposit support through brokered deposits.

Effective immediately, examiners should include comments in the liquidity, asset and liability management section of the report of examination of all banks that have total brokered deposits equal to or in excess of 5% of their deposits. This comment should include:

- the dollar amount of, and the extent of reliance upon such deposits for liquidity or other specified purposes
- the effect on interest margins, rate sensitivity, and possible adverse impact on asset quality
- the cost (interest and fees) compared to other available funding alternatives
- the extent and reasonableness of written policies and planning relative to their use
- the bank's ability to repay or replace brokered deposits with other sources of funds should they not be renewed, and
- criticisms of abuses in the acquisition or employment of these funds.

EC - 221

EXAMINING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type Examining Circular

Subject Brokered Deposits

District and Field Offices should evaluate these report comments when considering the need for and nature and content of supervisory responses. Each District is responsible for closely monitoring all banks that rely on brokered deposits as a significant source of funds.

In addition, for all banks rated "3", "4" or "5", OCC will address brokered funds in enforcement actions where brokered funds are now a problem or where we believe that brokered funds may exacerbate existing problems. As a practical matter, that means every bank, both delegated and non-delegated.

To deal with brokered funds in problem banks, OCC has developed a wide range of Articles to be used in enforcement documents. These Articles have been transmitted to each district office for their use. These Articles will be updated as circumstances warrant.

Originating Office

Chief National Bank Examiner's Office, Commercial Examinations Division, (202) 447-1684 and Deputy Comptroller for Special Surveillance, Special Projects Division, (202) 447-1484.

H. Joe Selby
Senior Deputy Comptroller
for Bank Supervision

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 330

FEDERAL HOME LOAN BANK BOARD

12 CFR Parts 561 and 564

Brokered Deposits; Limitations on Deposit Insurance

Dated: March 26, 1984.

AGENCIES: Federal Deposit Insurance Corporation and Federal Home Loan Bank Board.

ACTION: Final rule.

SUMMARY: The Federal Deposit Insurance Corporation ("FDIC") and the Federal Home Loan Bank Board ("Board"), as operating head of the Federal Savings and Loan Insurance Corporation ("FSLIC"), have adopted final regulations on deposits brokered by third parties into institutions whose accounts are insured by the FDIC or FSLIC ("insured institutions"). The regulations are intended to address the concern of the two Agencies with the problems arising from brokered funds, particularly in view of the recent decontrol of interest rates paid on deposits by insured institutions. As adopted, the regulations limit insurance coverage afforded to deposits placed with insured institutions by brokers engaged in the business of placing deposits, with certain specified exemptions.

EFFECTIVE DATE: October 1, 1984, with certain exceptions described in sections to be codified at 12 CFR 330.13 and 564.12.

FOR FURTHER INFORMATION CONTACT: Joseph A. DiNuzzo, Senior Attorney, Federal Deposit Insurance Corporation, Legal Division, (202) 389-4171, Room 4128B, 550 17th Street, N.W., Washington, D.C. 20429, or Christopher P. Bolle, Law Clerk, (202) 377-7057, or Robert S. Monheit, (202) 377-6465, Attorney, Federal Home Loan Bank Board, Office of General Counsel, 1700 G. Street, N.W., Washington, D.C. 20552.

SUPPLEMENTARY INFORMATION:

Background

On November 1, 1983, the FDIC and the Board ("Agencies") issued an *Advance Notice of Proposed*

Rulemaking, soliciting comments on the brokering of deposits of institutions whose accounts are insured by the FDIC or FSLIC ("insured institutions"). 48 FR 50399 (1983). The Advance Notice set forth the concerns shared by the FDIC and the Board about deposit brokerage, principally the swift receipt of large volumes of funds by insured institutions from outside their natural market areas irrespective of the institutions' managerial and financial soundness, and the increased costs to the FDIC and the FSLIC in the form of either greater insurance payments or higher assistance expenditures if the institutions are subsequently closed or merged because of insolvency. The Advance Notice posed a series of questions to the public concerning those issues and the possible means of dealing with them.

In January 1984, after reviewing the information received pursuant to the Advance Notice and other relevant data, the FDIC and the Board proposed amendments to their respective regulations governing the insurance coverage to be afforded deposits placed by or through brokers with insured institutions. 49 FR 2787 (1984). The proposal was designed to limit the insurance coverage on deposits placed by or through deposit brokers to $100,000 per insured institution per deposit broker. The term "deposit broker" was defined as any person or entity, other than an insured institution or its employee, engaged in the business of placing or listing for placement deposits of insured institutions. The proposal also limited insurance for deposit accounts established by a trustee or agent pursuant to an agreement to fund a prearranged loan. After careful consideration of the comments received and further analysis of other available information, the Agencies have decided to adopt the proposed amendments, with the modifications discussed below.

Overview of Comments Received

The FDIC received 3,498 comments on the proposed rule. The majority of these comments (2,823) were from individuals, with 281 from banks, 105 from savings and loan associations, 70 from brokers and other financial intermediaries, and 92 from credit unions. The other comments received were submitted by government agencies, local public units, Members of Congress, law firms, private businesses and trade associations.

The Board received 3,403 comments on the proposed rule, 2,776 of which were from individuals, 264 from savings institutions, 41 from commercial banks, and 104 from credit unions. Brokers and other financial intermediaries submitted 23 comments, and 195 letters were received from other entities, including government agencies, Members of Congress, law firms, trade associations and private businesses.

Virtually all the individuals who commented on the proposal identified themselves as customers of deposit brokers and opposed the rule, citing convenience, competitive rates and maturities, and liquidity of brokered funds. A small minority of individuals who commented favored the proposal, noting the negative economic implications of the abuses connected with brokered deposits. Credit union commenters, also identified as deposit brokerage customers, opposed the rule for similar reasons, noting that credit unions do not generally have the resources to place funds themselves in a cost-effective manner.

A slight majority of the banks that expressed an overall opinion about the proposal opposed it on the grounds of cost-effectiveness and the access to national markets provided by brokers. They recommended further supervisory action regarding the use of brokered funds. Banks favoring the proposal asserted that deposit brokerage increases an institution's cost of funds and could increase insurance premiums for all FDIC-insured banks, and causes funds to flow from local communities. The American Bankers Association and the Independent Bankers Association of America (the two major bank trade associations) supported the proposal.

One out of every twelve savings institutions (or 264 out of approximately 3,200 savings institutions) submitted individual comments. A slight majority of comments from individual savings institutions opposed implementation of the regulation as proposed, offering various approaches to ameliorate the problems addressed. Comments in opposition emphasized cost-effectiveness, competition and establishment of a national market, and the use of brokered funds for maturity matching. The National Council of Savings Institutions and the Texas Savings and Loan League also opposed the proposal. Thrifts favoring the rule referred to higher deposit liability costs to all institutions, resulting in higher borrowing costs; their major concern, however, is increased exposure of the deposit insurance funds and resulting increases in insurance premiums. The U.S. League of Savings Associations also favored the rule because of the threat brokered funds pose to the Insurance Fund. All but one of the state savings leagues which commented expressed general support for the proposed rule, although some suggested various modifications. These included the California League of Savings Institutions (California institutions hold sixty-three percent of all brokered deposits in the thrift industry), the New Hampshire Co-operative Savings and Loan League, the New York League of Savings Institutions, the New Jersey Savings League, the Ohio Savings and Loan League, the Florida League of Financial Institutions, the Pennsylvania Association of Savings Institutions, and the West Virginia League of Savings Institutions.

Deposit brokers and other financial intermediaries opposed the rule, which they argued was unfairly directed at them rather than at problems of institution mismanagement. These commenters warned of disruption in the secondary market for certificates of deposit with a consequent detrimental effect on individual investors and small and medium-sized institutions, and discrimination in favor of large institutions with the capacity to reach a national customer base. They recommended restricting the application of the rule to funds of "institutional" investors and funds invested in weak institutions, registration of deposit brokers with the Securities and Exchange Commission, and higher insurance premium assessments for institutions engaged in riskier activities.

Thirty-seven members of the United States Congress commented on the proposal; they acknowledged the negative aspects of deposit brokerage but requested that the Agencies defer action until Congress has had the opportunity to act on the matter. The Comptroller of the Currency criticized the proposal and recommended that the Agencies utilize a supervisory approach to the problems engendered by deposit brokerage; he suggested a limitation of $100,000 on the insurance coverage any single depositor could obtain on funds placed through any one broker, irrespective of the number of insured institutions involved. The Antitrust Division of the United States Department of Justice expressed the view that the proposal would cause competitive harm and recommended a more limited approach to the problem. The Comptroller and the Antitrust Division, as well as some other commenters, questioned the statutory authority supporting the restriction on deposit insurance coverage and the effectiveness and enforceability of the proposed approach.

Discussion of Issues Raised by Commenters

Statutory Authority

Several commenters expressed the view that the proposed rule would exceed express statutory authority regarding insurance coverage. They asserted a conflict between the proposal and the Congressional objective of protecting investors by insuring all deposits up to an aggregate amount per investor, pointing out that the federal deposit insurance system was intended to safeguard the savings of depositors, increase depositor confidence in financial institutions and promote economic growth through increased availability of credit.

Those commenters favoring the proposed approach frequently asserted that deposit brokerage has resulted in the misuse and exploitation of the deposit insurance funds. They noted that the legislative purpose in creating the federal deposit insurance system was to guarantee the safety of consumers' savings and not to maximize the investment yields of large investors. These commenters believe that deposit brokerage is unjustified and hazardous to the federal deposit insurance system.

The FDIC and the Board agree that insured deposit brokerage is inconsistent with the fundamental and overriding purposes which were meant to be served by the federal deposit insurance system. Deposit insurance was originally intended to establish stability and to promote confidence in the monetary and banking systems by protecting primarily small, relatively unsophisticated depositors in their relationships with banks and savings associations. It was not intended to protect investors seeking the highest yields available in money markets.

With regard to specific statutory authority, the Agencies note that they are clearly empowered to promulgate an insurance-limitation rule pursuant to provisions of the Federal Deposit Insurance Act (12 U.S.C. 1811–1832) and Title IV of the National Housing Act (12 U.S.C. 1724 *et seq.*) which expressly authorize the promulgation of "legislative" rules clarifying, defining, and limiting the insurance coverage provided, and the promulgation of rules proscribing unsafe or unsound practices. The FDIC and the Board have carefully observed explicit statutory limitations in this area (and, for example, have excluded certain IRA and Keogh accounts from coverage under this rule).

Cost of Funds to Insured Institutions

Insured institutions opposing restrictions to deposit brokerage activities frequently cited substantial savings realizable by obtaining deposits through brokers, and suggested that such cost savings could be passed along to the public. Many commenters view such funds as an inexpensive alternative to direct solicitation, especially for smaller institutions lacking extensive branch networks, and argued that only money-center banks would be capable of attracting lower-cost funds outside the local area.

Financial institution commenters supporting the proposal expressed alarm at the prospect of being subjected to the vagaries of the marketplace through heavy dependence on brokered deposits. Because brokered funds are typically generated outside of the depository institution's retail deposit base, the institution is forced to pay the highest national market rates to attract these funds, leading ultimately to increased costs for all institutions operating in the same retail deposit area. In the view of these commenters, the proposal would eliminate the deposit brokers' retailing of certificates of deposit to the highest bidder and would return the deposits to their deposit base—the local community—thus containing the cost of raising funds through retail deposits.

The Agencies note that opinion was divided as the the actual effect of the use of brokers on an insured institution's cost of funds. Those who alleged that brokered deposits are less expensive often offered a branch network as the alternative, and did not consider the relative costs of raising funds through other low overhead means such as direct solicitation, advertising and deposit-listing services, none of which would be affected by the new rule.

Investor Convenience

Individual commenters generally praised the convenience of placing deposits in insured institutions through investment brokers. Many commenters stated that use of these third-party intermediaries provided small investors with access to national markets, permitting wider choices of deposit instruments, interest rates and maturities formerly available only to large investors. Commenters also cited the liquidity of brokered CDs facilitated by the active secondary market in these instruments.

The Agencies understand the desire of individual investors to use the most convenient method of obtaining high protected yields. The FDIC, however, does not agree that deposit insurance was ever intended to facilitate shopping by investors for the highest yields available in national money markets, irrespective of the credit-worthiness of the borrowing institutions. The Board concurs, and finds that limiting insurance of deposits placed through brokers is not necessarily detrimental to the investor's goal; deposit-listing services, for example, may offer a wider choice than a broker who merely recommends a particular depository. Furthermore, it does not appear unreasonable that investors should choose between accepting a broker's judgment as to the safety of an uninsured investment and doing minimal research to find an insured investment. An investor who believes that only a broker can offer the convenience needed may continue to use such a service, but full deposit insurance will not be provided to that investor.

Capital Markets

Redistribution of funds from "capital rich" to "capital poor" markets was frequently mentioned as a desirable by-product of deposit brokerage. Commenters suggested that this redistribution provided funds for housing and other lending needs in many areas of the country. In addition, many institutions viewed brokered CDs as valuable tools in balancing their assets and liabilities. Several commenters suggested that the prudent use of brokered funds could assist struggling institutions in restructuring their operations, ultimately saving the Insurance Funds from costly assisted mergers or liquidations.

The Agencies have seen no evidence that brokered funds move capital from one area to another in ways that are uniquely helpful to the financial institutions involved or to their depositors and borrowers. Rather, it appears that brokered funds move to the institutions willing to pay the highest rate, wherever located. Other mechanisms can be used to aid institutions in cash-poor areas in raising capital, such as the inter-bank market, advertisements, stock or debt sales, and secondary market activity in loans. In the view of the Board and the FDIC, there is not compelling reason to permit continued brokering of insured deposits to meet these needs when there are other less objectionable means available. Moreover, one comment, indicating that without brokered funds the commenting institution could not even meet its current obligations to pay interest on outstanding instruments, illustrated precisely the kind of dangerous "capital movement" practice the rule is intended to curb. Funds flows should be based on the creditworthiness of the borrowing institution, not simply the rate of interest paid on a federally guaranteed instrument.

Appropriateness of Mechanism Based on Supervisory Concerns

The FDIC and the Board have reviewed their data on banks and savings associations which are involved with deposit brokerage. Indications are that, although brokered deposits at the present time comprise a modest percentage of total domestic deposits, a significantly greater proportion of poorly-rated institutions use brokered deposits than highly-rated institutions. The 77 commercial banks that failed in 1982 and 1983 had substantial brokered deposits, constituting, on the average, 16 percent of total deposits. In three instances, brokered deposits equalled more than 80 percent of the failed bank's total deposits. In 19 other cases, these deposits equalled between 20 and 50 percent of the failed bank's deposits. As of mid-March 1984, 13 commercial banks had failed in 1984; seven of these held brokered deposits ranging as high as 53 percent of total deposits.

In savings associations insured by the FSLIC, brokered deposits totaled approximately $3 billion in January, 1982, and had increased tenfold to almost $30 billion by December, 1983. Moreover, there has been a significant correlation between associations which use brokered deposits and those which have supervisory problems. In 1982 and 1983, more than half of the insured institutions that were closed by the FSLIC had brokered funds in excess of one-third of their deposits. Almost half of the institutions with a net worth below acceptable levels have brokered deposits in excess of 20 percent of their total deposits. For example, in one case, an institution had $240 million in brokered deposits, representing 90 percent of its deposit base. Another problem association used brokered deposits to increase its assets by over 2,500 percent, with brokered deposits representing 70 percent of its total liabilities. In 1983, only 670 of the approximately 3,200 FSLIC-member institutions reported any use of brokered deposits. The use of brokered deposits is even more highly concentrated than that figure indicates: 94 percent of all brokered deposits are concentrated in the 369 FSLIC-insured institutions (approximately one-tenth of the industry) that hold brokered deposits in excess of 5 percent of total deposits, and of these, 145 are troubled institutions. The FDIC and the Board are continuing to collect information on deposit brokerage and, as discussed below, are monitoring the use of brokered funds by problem institutions.

Commenters have questioned these figures by suggesting that a large portion of the brokered funds of recently failed banks and thrifts are in fact uninsured deposits of institutional investors. Cases handled recently indicate that quite the opposite is true, and suggest that, since the occurrence of several highly publicized depository institution failures, the great majority of investors have sought full insurance coverage of deposits.

In addition to their concern about the effects of deposit brokerage on already troubled institutions, the FUIC and the Board are concerned about the potential which exists for the abuse of brokered funds by insured institutions generally. There are a number of reasons why currently sound institutions might succumb to the opportunity to swiftly and dramatically increase their deposit size through massive infusions of brokered funds. These funds, which are often received in large amounts at high cost, must be invested quickly for purposes of economic efficiency. The Agencies' experience has shown that the speed required may not allow for the usual care to be taken in appraisals and credit checks relative to investments. Moreover, the need to offer a high rate of return to attract brokered funds may require institutions to take greater investment risks, a factor often aggravated where the broker or associated parties suggest or stipulate particular uses for the funds. Healthy institutions may become problem cases very quickly through a very few transactions of this sort. One institution, for example, used brokered deposits to quadruple its asset size in a year. Although this institution was healthy at the outset of the year, the brokered funds were used to invest in highly speculative commercial loans at a pace that precluded the association from using adequate underwriting procedures, so that it is now a problem for the FSLIC. In another transaction, brokered funds were deployed to fund transactions where the value of security properties were artificially inflated to levels bearing no resemblance to real value as security for loans.

Although only a small percentage of institutions currently engage in the brokered deposits market, the Board believes the expanded use of such funds could have a significant effect on the entire insured depository industry. If brokered deposits grew into a dominant source of funds, it is possible that high national market rates would become a "floor" even in remote areas, and therefore, as a commenter observed, raise the cost of home loans and other consumer borrowing, or force institutions into making more speculative investments in order to cover the cost of funds. In addition to increasing the cost of money, such a situation also could result in a standardization of terms and the imposition of minimum amounts of deposits.

The Board also in concerned that the continued use of brokered funds could, through the use of nationwide brokers, draw institutions away from direct contact with their local communities and that the "local nexus" could be lost. Particularly troublesome is the possibility that, if institutions rely heavily on brokered funds rather than the local savings base, they will feel less need to respond to the housing and credit needs of their local communities.

Several commenters suggested that the Agencies adopt a differential approach to the treatment of brokered funds. It was suggested that the funds be divided into uninsured accounts, insured individual accounts and insured institutional accounts. Only the latter would be regulated, since commenters asserted that these accounts represented the greatest risk to the Insurance Funds because they frequently are placed by brokers not registered with the SEC and do not receive the prudent analysis of risk enjoyed by insured individual depositors.

This approach is discussed in more detail in the section describing alternatives considered. In brief, however, the Agencies see no reason to differentiate between these two types of deposit: Both sources of funds are placed by brokers and result in large sums moving rapidly among institutions.

A number of commenters questioned the enforceability and effectiveness of the proposed approach. They expressed the belief that weak institutions could easily circumvent the proposed restrictions by advertising directly in nationally circulated newspapers or merely by bringing the brokerage function in-house. Further, the use of brokers could be concealed from deposit insurers, encouraging troubled institutions to use subterfuge as to the origin of deposits. Finally, these commenters noted that neither the Agencies nor the depository institution could easily distinguish between brokered deposits placed by individuals directly (although on the advice of a deposit-listing service) and other more readily ascertainable types of brokered deposits, thus making enforcement even more difficult.

The FDIC and the Board believe that institutions will comply with the final rule, and that attempts at evasion would be discovered in the course of regularly scheduled examinations through detection of account patterns. In addition, institutions probably would be unwilling to participate in such arrangements because of the uncertainty of ultimate insurability. Finally, the Agencies do not believe brokers would participate in such activities because the potential discovery of evasion could result in significant broker liability.

Consideration of Alternative Approaches

Many commenters suggested alternatives to the approach taken by the proposed regulation.

1. Focus on Institutional accounts. Several commenters recommended that a distinction be made between institutional and individual investors, and insured and uninsured brokered funds. They allege that insured institutional deposits, comprising less than 10 percent of the market, in which deposits are broken into $100,000 lots to achieve full insurance coverage, pose the most risk to the Insurance Funds because they generally are short-term and are largely placed by unregulated money brokers without the benefit of credit analysis.

The FDIC and the Board believe that this approach would not accomplish their objectives, and would not address many of the problems inherent in brokered funds. Even if the characterization of institutional insured brokered deposits is accurate, it does not argue strongly for a different approach: an account with a longer maturity does not carry the imminent threat of nonrenewal, but is nonetheless subject to the same reinvestment problems as a shorter-term account. Furthermore, the Agencies have not been presented with convincing evidence that there are significant differences between brokers of institutional funds and brokers of individuals' deposits; there are brokers of institutional funds who are registered, use credit analysis, and carefully select insured banks and thrifts for their clients, while brokers for individual investors have not been immune from placing deposits in troubled institutions. Assuming that a difference does exist, a rule allowing continued insurance of individual investors would merely invite institutional brokers to enter the individual investor market and to continue their allegedly inadequate practices. Moreover, the growth of the money market mutual fund industry indicates that insured third-party deposit brokerage, even if limited to the deposits of individuals, would continue to proliferate and present problems similar to those presented today.

2. Focus on Troubled Institutions Only. Commenters suggested limiting application of the regulation to institutions which fall below required levels of net worth or pose other supervisory problems.

The FDIC and the Board already have taken certain actions in this area and are proposing additional steps. The FDIC currently requires all of its regulated institutions subject to an enforcement action or party to a memorandum of understanding with the FDIC to notify the FDIC before the institution's proportion of brokered deposits to total deposits exceeds five percent. The Board has issued a supervisory directive, dated October 28, 1983, requiring any insured institution failing to meet its regulatory net-worth requirement to give ten days' notice prior to increasing its use of brokered funds to a level above five percent of total deposits, along with information indicating the sources and expected uses of the funds. In addition, the Board today is adopting a temporary regulation limiting to five percent of assets the amount of brokered deposits that may be taken in by an institution with net worth below a certain level; that regulation is intended to prevent unsafe practices by thinly-capitalized institutions which might seek to increase unreasonably their levels of insured brokered deposits prior to the October 1 effective date of the regulation set forth in this Resolution.

However, focusing only on the access of particularly vulnerable banks and thrifts to brokered funds would not prevent abuse by such institutions that were not of supervisory concern prior to their last examination, nor would it effectively protect the FDIC and the FSLIC from increased liabilities stemming from the actions of desperate bank or thrift managers willing to violate regulations in a gamble to use brokered deposits to stave off failure. In one case, a State-chartered, FSLIC-insured thrift institution raised over $40 million in brokered deposits in two days and used these funds to finance a transaction in direct violation of a State cease-and-desist order; while the State regulatory authority may take disciplinary action against the management of that institution, the cost to the FSLIC to resolve the case will nonetheless increase significantly.

The insurance-limitation rule will be "self-implementing" and thus very effective, without imposing substantial regulatory or reporting requirements, and it will encourage the market to discipline investors and recipients of brokered deposits. The rule also reduces the risk to the FDIC and the FSLIC from potential increased liabilities incurred by mangement in supervisory situations.

3. Limit Deposit Growth. Other comments suggested that limitations be placed on the rate of all deposit growth of institutions, based upon varying percentages of net worth, assets, liabilities or other determinants.

The FDIC and the Board find the suggestions to limit or monitor the deposit growth of all insured banks and thrifts to be a more burdensome regulatory approach. The FDIC believes that it is not apparent how any particular limit could be arrived at or supported. Moreover, any limit, such as 15 percent of deposits, which has been suggested by some, would be excessive for poorly operated institutions and unduly restrictive for institutions with strong management and financial ratios. The insurance-limitation approach allows each institution to utilize brokered funds to the extent it can attract them based on its own creditworthiness. The Board concurs, and notes that a rule effectively limiting but not over-regulating deposit growth could be quite complex; such an approach could impose significant regulatory burdens on types of growth that occur more slowly and therefore are of less regulatory concern than the use of brokered funds.

4. Registration of Brokers. A significant number of commenters recommended that all deposit brokers be required to register with the Securities and Exchange Commission ("SEC").

The Agencies find that requiring registration of brokers with the SEC would be a meaningless exercise so long as their customers' deposits were fully insured by the FDIC or the FSLIC, because there would be no market discipline in the placement of deposits. In this connection, the Agencies have found that SEC-registered brokers have not been immune from placing brokered deposits into troubled banks and thrifts; registering additional brokers will not provide additional assurances. Further, SEC registration requirements would not protect the FDIC or FSLIC funds, because they are not oriented toward the safety and soundness of insured institutions or the deposit insurance funds.

5. Variable-rate Insurance Premiums. A number of commenters recommended that deposit insurance premiums either be increased or varied to reflect the increased risk factor created by deposit brokerage. The FDIC believes risk-related deposit insurance premiums should be implemented and has requested Congress to enact enabling legislation. Risk-related premiums, however, would not be a panacea. Assessment of higher premiums might discourage the acquisition of troubled banks or thrifts, or increase the amount of federal financial assistance required in connection with supervisory solutions for such institutions. A variable insurance premium, even if authorized, would not necessarily solve the problems addressed by the final rule. Such a premium structure, if based upon the level of brokered funds, could also invite circumvention through manipulation of brokered-deposit levels during phases of reporting periods. Consistent with the goals of deregulation, the insurance-limitation rule will act to deter investors from placing deposits in what the *market* determines to be high-risk institutions, rather than trying to deter such institutions from making investments that the *regulators* believe are high-risk. Lastly, the variable-premium suggestion erroneously assumes that the Congress intended insured banks and thrifts to pay higher premiums in order to permit deposit brokers to continue to profit through the marketing of FDIC- or FSLIC-insured products.

6. Increased Supervisory Efforts. A substantial number of commenters recommended increased examinations, reporting requirements and other forms of supervision to regulate the investment practices of institutions utilizing brokered funds. These alternatives could be applied to all institutions, or only to those experiencing net-worth deficiencies or other supervisory problems, or could be tied to a scale depending on the institution's rating, net worth, capital, or any other measure of economic viability. The Agencies have considered these alternatives, but believe that they would require constant monitoring, and would only serve to increase the regulatory burden on depository institutions and supervisory role of the Agencies. This is contrary to the spirit of deregulation and would necessitate an increase in the staff and costs of the Agencies, while doing little to protect the Insurance Funds from institutions unconcerned with the consequences of regulatory violation. Also, the ability of institutions to raise millions of dollars in brokered funds in a very short period would render ineffective any provision for additional monitoring or reporting, because the damage would already have been incurred.

7. Prohibition or Limitation on Receipt of Brokered Funds. The Agencies also considered a blanket prohibition on the use of brokered deposits, but rejected it because it would totally eliminate the benefits to insured institutions of brokered deposits. A stringent limitation would have much the same effect, and a generous percentage would allow continuation of current abuses. Limiting the insurance coverage of brokered deposits, on the other hand, will not defeat the liquidity benefits of brokered deposits for well-run institutions. Such deposits will still be obtainable, but without the insurance guaranty. Investment decisions will have to be made on the basis of analysis of the strength or weakness of the involved depository institution, and not on the insurance feature of the deposit. Inasmuch as a number of deposit-broker comments have indicated that this process has already been established for their individual investor depositors, the new rule should not prove unduly burdensome.

After careful consideration of all of the alternatives, the FDIC and the Board have found the insurance-limitation approach to be the most effective method for addressing the problems presented by the growth of brokered deposits in a deregulated environment. Further, the final rule achieves the Agencies' intended purposes by using market discipline rather than by imposing burdensome regulatory and reporting requirements. The alternatives suggested are, in contrast, ineffective and/or overly burdensome, and all assume that the Congress intended deposit brokers to benefit through the marketing of FDIC- or FSLIC-insured products without being directly subject to regulations intended to ensure the soundness of the Insurance Funds.

Explanation of the Rule

The Definition of Deposit Broker

Many commenters suggested modifications to the definition of the term "deposit broker" contained in the proposal. Most recommended exemptions of certain groups from the definition, such as beneficial owners of IRA, Keogh and qualified pension and profit-sharing plans and part-time investment advisers/agents, typically affiliated with small, community-based depository institutions. Other commenters urged a broader definition to encompass persons or entities, such as real estate and insurance agents, who solicit deposits generally for insured depository institutions lacking extensive branch networks. Other commenters, responding to a question posed in the proposal, recommended inclusion of insured institution subsidiary/joint ventures within the scope of the definition of deposit broker.

The final rule limits the insurance coverage of funds placed by or through a "deposit broker" to $100,000 per broker per insured institution. This differs from the current FDIC and Board regulations which, if certain requirements are met, deem the customer of the deposit broker to be the "depositor" or "member." "Deposit broker" is defined as any person or entity engaged in the business of placing deposits for others, or of placing funds in accounts to be sold to others, and an agent or trustee who establishes a deposit or member account in connection with an agreement with the institution to use the proceeds in the account to fund a prearranged loan.

The definition of "deposit broker" includes not only deposit brokerage arrangements where the broker is the holder of an account for a number of principals, but also where the broker directs or otherwise facilitates the transfer of funds of depositors to an institution without itself becoming a holder of an account. Except for the situations noted below, the definition includes anyone in the business of placing funds in an account for a third party, whether or not the deposit broker is the legal or beneficial owner of the account, and whether or not the placement of funds in accounts is that person's primary business. The term "deposit broker" excludes a depository institution which generates deposits for itself, but includes depository institutions generating deposits for other depository institutions. Also, the definition includes subsidiaries, service corporations or affiliates which place funds with related depository institutions. Likewise, no exception is made for depository institutions either owned by or affiliated with securities firms.

The definition does not include employees of depository institutions. Because the agencies are concerned, however, that too broad a definition of "employee" would lead to circumvention of the intent behind the proposed amendments, the rule adopts the proposed definition of an "employee" of an institution as a person: (1) Who is employed exclusively by the institution for which he or she is soliciting deposits; (2) whose primary compensation is in the form of a salary; (3) who does not share his or her compensation with a deposit broker; and (4) whose office space or place of business is used exclusively for the benefit of his or her institution/employer.

The definition of "deposit broker" does not generally include trust departments of insured institutions; however, where a deposit broker places deposits through a trust department, all funds placed by that deposit broker will be insured only up to $100,000. Also, a trust department would be deemed a deposit broker in connection with trusts established primarily for the purpose of placing funds with insured institutions.

The definition of "deposit broker" in the proposed rule included all deposit-listing services. In light of the comments and other available information, the Agencies have concluded that it would be infeasible to identify deposits that are placed by reference to listing services that did not actually facilitate the placement of funds with insured institutions. In addition, where the only function of a deposit listing service is to provide information on the availability and terms of accounts, the Agencies believe that the service's minimal participation in the placement process does not merit treatment as a deposit broker. Therefore, the Agencies have specifically excluded from the definition of "deposit broker" any deposit-listing service that does not receive a commission for the number or amount of deposits placed as the result of its service, if the service provided is limited to the collection and transmission of information on the accounts available, and the customer, rather than the deposit-lister or its agent, transmits the funds to the insured institution.

The FDIC and the Board do not intend to disturb traditional deposit relationships. Accounts held by agents will remain insured up to $100,000 per principal, provided that the agent is not engaged in the business of placing deposits. Thus, arrangements such as real estate agent accounts and attorney escrow accounts will not be affected by the amendments because such accounts are held for a purpose incidental to the ordinary business activities of the agent.

Some commenters expressed concern that the rule as proposed could limit the insurance coverage available to trustees under the current regulations. While the agencies do not intend to alter the coverage currently available to traditional trust arrangements, they are concerned that a blanket exemption of all trustees from the definition of deposit broker could lead to substantial circumvention of the rule through various trust-type mechanisms. The final rule therefore exempts trustees from the definition of "deposit broker" provided that the trust in question is not used primarily for the purpose of placing funds in insured institutions. This will preserve the current insurance coverage for trusts while limiting the usefulness of trusts as devices to circumvent the rule.

The insurance coverage currently available to deposits held in connection with pension funds and other employee benefit plans will not be affected by the rule unless such deposits are placed by or through a deposit broker. In addition, trustees and custodians of IRA and Keogh accounts will not be deemed to be deposit brokers. Likewise, the insurance coverage of accounts of public units will not be affected, provided that a deposit broker is not employed to place the funds.

In situations where deposits of pension or other employee-benefit plans are placed by plan administrators or investment advisors, such deposits will not be deemed "placed by or through a deposit broker" as long as such plan administrator or investment advisor plays a managerial role relative to the applicable pension or employee-benefit plan. The reason for this exception is to prevent undue disruption in the pension-fund industry and to further the intent of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1001–1461).

Negotiable Certificates of Deposit

Under the current regulations, for insurance purposes, the "depositor" of a negotiable or bearer-form deposit is the person holding the deposit on the date the institution is closed because of insolvency. 12 CFR 330.11 and 570.11. The Agencies were concerned that such deposits might be used to subvert the intent of the proposed amendments, and requested comments on amendments to current rules which would address this potential problem. After careful consideration of comments received in this regard, the Agencies have determined that it is not appropriate at this time to impose any special restrictions on negotiable certificates. The FDIC and the Board will monitor this area and will take appropriate action in the future if necessary.

Effective Date

The Agencies received numerous comments with regard to the effective date of the regulation. Some commenters endorsed an earlier effective date, while others supported a more gradual phase-out of insurance for brokered deposits. Still others recommended immediate emphasis on existing supervisory remedies for troubled institutions in conjunction with continued study of the issue, including deferral to legislative initiatives. The Agencies also received a petition for revision of this rulemaking process and request for an extension of the comment period from an owner of a listing service; the Board and the FDIC are taking this opportunity to deny that petition and request because they believe it essential that the issue of brokered funds abuse be promptly addressed, particularly in view of the recent decontrol of interest rates. The Agencies believe that the public has had ample time, during the comment periods provided for in the Advance Notice and the Proposal, to express its views on the issues raised by deposit brokerage and the means of addressing those issues.

The effective date for the final rule, as stated in the proposal, is October 1, 1984. Thus, except for the situations noted below, any brokered deposits placed or renewed on or after October 1, 1984, will be subject to the new regulations on insurance coverage. All deposits with insured institutions prior to October 1, 1984, irrespective of whether they would qualify as brokered deposits under the final rule, will be insured until their maturity dates under the regulations predating the final rule. The purposes of the delayed effective date and continuation of insurance on accounts existing before that date are: (1) To fulfill depositors' expectations as to terms and conditions of existing deposits which, because of the term remaining, could not be withdrawn without imposition of a penalty for early withdrawal; (2) to allow institutions relying heavily on brokered deposits time to adjust their deposit structures; and (3) to provide for an orderly adjustment of funding techniques. Based on their examination of the problems facing institutions in adjusting to the effects of the rule, and their analysis of comments received, the Agencies have concluded that an effective date of October 1, 1984, provides enough time for institutions and the purchasers of brokered deposits to adjust their business practices.

Questions arose in the comments about the treatment to be afforded money market deposit accounts ("MMDAs") and other accounts without existing maturities placed before October 1, 1984. The issue was raised whether such accounts placed by or through a broker prior to the effective date of the final rule would be insured under the pre-existing regulations until the funds are withdrawn or whether the insurance coverage on those accounts would change as of the effective date of the rule. Upon consideration of the comments, the Agencies have decided that funds in such accounts placed by brokers with insured institutions before

October 1, 1984, will be insured under the insurance coverage rules predating the final rule until November 30, 1984. This treatment allows for a two-month period after the general effective date of the final rule in which holders of such accounts may adjust their deposit-placement practices. Deposits with no fixed Maturities placed by brokers on or after October 1, 1984, will be subject to the final rule and its general effective date of October 1, 1984.

Certificates of deposit held in trust for bondholders under "loans-to-lenders" or industrial development bond ("IDB") programs are covered by the final rule. These programs entail a transaction where the proceeds of an IDB issuance are placed with an insured institution, in exchange for a certificate of deposit, to fund a designated project. Because of the trust arrangement involved, under the Agencies' current insurance coverage rules each bondholder owns an insured interest in the deposit up to $100,000 and the deposit, therefore, may be fully insured by either the FDIC or the FSLIC. The final rule will limit the insurance coverage of such deposits to $100,000 inasmuch as it specifically defines a trustee in this type of transaction to be a "deposit broker." Thus, beginning October 1, 1984, IDB programs will no longer be buttressed by full deposit insurance. A question arises, however, about existing IDB programs in which the deposit in question has a term shorter than the period of the underlying loan, as opposed to the date of the maturity of the underlying bond. If such existing deposits are deemed to be placed or renewed after October 1, 1984, under the final rule, they will be subject to the new regulations and will therefore be ineligible for multiple insurance coverage. Such a result would trigger acceleration of the maturity dates of the underlying bonds, an event which could result in the bankruptcy of the project and severe liquidity problems for the involved depository institution. In order to avoid this undue hardship, and because of the mandatory nature of the rollover provisions in the bond indentures, the Agencies believe that the maturity dates of such deposits should be deemed to be those of the bonds they secure. Therefore, the final rule provides that deposits issued by an institution to a trustee who is a "deposit broker" with respect to such certificates under either § 330.0(b)(2) or § 561.2a(a)(2) shall not be deemed to be renewed, for purposes of the regulation, unless such renewal is discretionary. This exception will apply only to IDB transactions entered into prior to October 1, 1984.

As already noted, brokered deposits placed or renewed on or after October 1, 1984, will be subject to the restrictive insurance coverage provisions of the final rule. Upon considering the many comments on this issue and analyzing other available data, the Agencies believe it is necessary to safeguard against liquidity problems for insured institutions that have relied heavily in the recent past on brokered deposits as a source of funding. Thus, the final rule provides that brokered deposits held at insured institutions on the date the final rule is adopted by the Agencies may be renewed one or more times by the depositor within a period of two years after the effective date of the final rule (up to October 1, 1986) and continue to qualify for deposit insurance under the regulations predating the final rule until their first maturity after October 1, 1986. However, such deposits may not be renewed for a dollar amount greater than their original denomination, and must be held by the owners in their individual capacities. Deposits held prior to the date of adoption of the final rule (March 28, 1984) in custodial or trust capacities by or through deposit brokers may become eligible for this "rollover" exception only if, by June 30, 1984, the institution is provided with the names and ownership interests of the parties for whom such deposits are maintained. The resulting insurance coverage will then apply only to the owner so identified.

Final Regulatory Flexibility Analysis

Pursuant to section 3 of the Regulatory Flexibility Act, Pub. L. No. 96-354, 94 Stat. 1164 (Sept. 19, 1980), the FDIC and the Board are providing the following regulatory flexibility analysis:

1. *Reasons, objectives, and legal bases underlying the rules.* These elements have been incorporated elsewhere in the supplementary information regarding the rule.

2. *Small entities to which the rules apply.* The rules apply to insured institutions.

3. *Impact of the rules on small institutions.* As brokered deposits do not yet constitute a significant portion of total deposits of most insured institutions, the rules will not have a significant impact on a substantial number of small entities.

4. *Overlapping or conflicting federal rules.* There are no federal rules that duplicate, overlap, or conflict with this rule.

5. *Alternatives to the rules.* The rule limits federal deposit insurance on brokered deposits. Other alternatives considered, such as increased monitoring and approval mechanisms and blanket prohibitions on brokered deposits, would be more burdensome to the regulatees or would eliminate the benefits of a regulated activity, including availability of liquidity.

List of Subjects

12 CFR Part 330

Bank deposit insurance, Banks, Banking.

12 CFR Parts 561 and 564

Bank deposit insurance, Banks, Banking, Savings and loan associations.

Accordingly, the FDIC hereby amends Part 330 of Title 12 of the Code of Federal Regulations and the Board hereby amends Parts 561 and 564 of Title 12 of the Code of Federal Regulations as set forth below.

PART 330—CLARIFICATION AND DEFINITION OF DEPOSIT INSURANCE COVERAGE

1. The authority citation for Part 330 is as follows:

Authority: 12 U.S.C. 1813, 1817, 1819, 1821, 1822.

2. Section 330.0 is hereby revised as follows:

§ 330.0 Definitions.

(a) For the purpose of this Part 330, the term "insured bank" includes an insured branch of a foreign bank.

(b) Except as provided in paragraph (c) of this section, the term "deposit broker" includes: (1) Any person engaged in the business of placing funds, or facilitating the placement of funds, of third parties with insured banks or the business of placing funds with insured banks for the purpose of selling interests in those deposits to third parties; and (2) an agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured bank to use the proceeds of the account to fund a prearranged loan.

(c) The term "deposit broker" shall not include the following: (1) An insured bank, with respect to funds placed with that bank; (2) an employee of an insured bank, with respect to funds placed with his or her employer/bank; (3) a trust department of an insured bank or of an institution insured by the Federal Savings and Loan Insurance Corporation, provided that the trust in question has not been established for the primary purpose of placing funds with insured depository institutions; (4) the trustee of a pension or other employee benefit plan, with respect to funds of the plan; (5) a person acting as a plan administrator or an investment adviser in connection with a pension plan or other employee benefit plan provided that that person is performing managerial functions with respect to the plan; (6) the trustee of a testamentary account under section 330.3 of this Part; (7) the trustee of an irrevocable trust (other than one described in paragraph (b)(2) of this section), as long as the trust in question has not been established for the primary purpose of placing funds with insured depository institutions; (8) a trustee or custodian of a pension or profit sharing plan qualified under section 401(d) or 408(a) of the Internal Revenue Code of 1954, as amended; (9) an agent or nominee whose primary purpose is not the placement of funds with depository institutions.

(d) The term "employee," for purposes of this section only, includes only an employee: (1) Who is employed exclusively by the insured bank for which he or she is soliciting deposits; (2) whose compensation is primarily in the form of a salary; (3) who does not share his or her compensation with a deposit broker; and (4) whose office space or place of business is used exclusively for the benefit of his or her insured bank/employer.

(e) For purposes of this section only, the term "business of placing funds or facilitating the placement of funds" shall not include deposit listing services where: (1) The person or entity listing the deposit is compensated only by means of a subscription fee which is not calculated on the basis of the number or dollar amount of deposits placed as the result of information provided by such service; (2) the service provided is limited to the gathering and transmission of information concerning the availability of deposits; and (3) any funds to be invested in deposit accounts are remitted directly by the depositor to the insured bank and not, directly or indirectly, through the person or entity providing the listing service.

3. Section 330.2 is hereby revised as follows:

§ 330.2 Individual accounts.

Funds owned by an individual (or by the community between husband and wife of which the individual is a member) and deposited into one or more deposit accounts in his or her own name shall be insured up to $100,000 in the aggregate.

4. Section 330.10 is hereby revised as follows:

§ 330.10 Trust accounts.

All trust interests for the same beneficiary deposited into deposit accounts established pursuant to valid trust agreements created by the same settlor (grantor) shall be added together and insured up to $100,000 in the aggregate, except time and savings deposits of the same beneficiary which qualify as pension or profit sharing plans under section 401(d) or 408(a) of the Internal Revenue Code of 1954, as amended. The vested and ascertainable interest (excluding any remainder interest) of each beneficial owner in a time or savings deposit established under either of the above sections, shall be added together and insured to an additional $100,000 maximum for each beneficial owner, notwithstanding the insurance provided in this section to other types of deposit accounts. Except where the trustee is a deposit broker, the insurance of such trust interests shall be separate from that afforded deposit accounts of the trustee of such trust funds or the settlor or beneficiary of such trust arrangement.

5. Section 330.13 is hereby added as follows:

§ 330.13 Accounts held by or established through intermediaries.

(a) Except as provided in paragraph (b) of this section, funds owned by a principal and deposited into one or more deposit accounts in the name or names of agents or nominees shall be added to any individual accounts of the principal and insured up to $100,000 in the aggregate.

(b) Notwithstanding any other provision of this part, funds deposited into one or more deposit accounts by or through a deposit broker shall be added to any other deposits placed by or through that deposit broker and insured up to $100,000 in the aggregate. This subsection shall apply to all accounts opened, added to, or renewed on or after October 1, 1984, except that it shall not apply until:

(1) Either October 1, 1985, or the maturity date of the deposit account, whichever is later, with respect to renewals of all time deposits in existence on March 20, 1984, provided that: (i) Only the interests of persons in such accounts as of March 20, 1984, shall be recognized for purposes of insurance coverage; and (ii) the identities and interests of those beneficial owners are reflected on the books and records of the bank by June 30, 1984;

(2) November 30, 1984, with respect to deposit accounts which have no specified maturity date; and

(3) The maturity date of the corresponding loan with respect to renewals of deposits established before October 1, 1984, by a person who is a deposit broker under section 330.1(b)(12) of this part, only if renewals of such deposits are mandatory under the underlying account agreement.

(c) Funds held by a guardian, custodian or conservator for the benefit of a ward or for the benefit of a minor under a Uniform Gifts to Minors Act and deposited into one or more accounts in the name of the guardian, custodian or conservator shall be added to any individual accounts of the ward or minor and insured up to $100,000 in the aggregate.

SUBCHAPTER D—FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

PART 561—DEFINITIONS

1. The authority citation for Part 561 is as follows:

Authority: 12 U.S.C. 1724, 1725, 1726, 1728, 1730.

2. Add new § 561.2a, as follows:

§ 561.2a Definition of "deposit broker."

(a) Except as provided in paragraph (b) of this section, the term "deposit broker" includes: (1) Any person engaged in the business of placing funds, or facilitating the placement of funds, of third parties in accounts issued by an insured institution or the business of placing funds in accounts issued by insured institutions for the purpose of selling interests in such accounts to third parties; (2) an agent or trustee who establishes an account to facilitate a business arrangement with the institution to use the proceeds of the account to fund a prearranged loan.

(b) The term "deposit broker" does not include the following: (1) An insured institution, with respect to accounts issued by that institution; (2) an employee of an insured institution, with respect to accounts issued by his or her employer; and (3) a trust department of a bank, the accounts of which are insured by the Federal Deposit Insurance Corporation, or of an insured institution, provided that the trust in question has not been established for the primary purpose of placing funds in accounts issued by insured depository institutions; (4) the trustee of a pension or other employee benefit plan, with respect to funds of the plan; (5) a person acting as a plan administrator or an investment adviser in connection with a pension or other employee benefit plan, provided that that person is performing managerial functions with respect to the plan; (6) the trustee of a testamentary account; (7) the trustee of an irrevocable express trust (other than one described in paragraph (a)(2) of this section), provided that the trust in question has not been established and is not being used primarily for the purpose of placing funds in accounts issued by insured institutions; (8) the trustee or custodian of a pension or profit-sharing plan which qualifies under sections 401(d) or 408(a) of the Internal Revenue Code of 1954 as amended; and (9) an agent or custodian, provided that the primary function of the relationship pursuant to which the funds are invested is not investment of funds in insured accounts.

(c) The term "employee," for purposes of this section only, includes only an employee: (1) Who is employed exclusively by the institution for which he or she is soliciting deposits; (2) whose compensation is primarily in the form of a salary; (3) who does not share his or her compensation with a deposit broker; and (4) whose office space or place of business is use exclusively for the benefit of his or her institution/employer.

(d) For purposes of this section, the term "business of placing funds or facilitating the placement of funds" does not include the provision of deposit-listing services where: (1) the person or entity providing the service is compensated only by means of a subscription fee which is not calculated on basis of the number or dollar amount of accounts placed as a result of information provided by such service; (2) the service provided is limited to the gathering and transmission of information concerning availability of accounts; and (3) any funds to be invested in accounts are transmitted directly to the insured institution by the depositor and not, directly or indirectly, through the person or entity providing the listing service.

PART 564—SETTLEMENT OF INSURANCE

3. The authority citation for Part 564 is as follows:

Authority: 12 U.S.C. 1724, 1725, 1726, 1728, 1730.

5. Revise § 564.3 as follows:

§ 564.3 Individual accounts.

Funds owned by an individual (or by the husband-wife community of which the individual is a member) and invested in one or more accounts in his or her own name shall be insured up to $100,000 in the aggregate.

6. Amend § 564.10 by adding a sentence at the end thereof, as follows:

§ 564.10 Trust accounts and IRA and Keogh accounts.

* * * Except where the trustee is a deposit broker, the insurance of such trust interests shall be separate from that afforded deposit accounts of the trustee of such trust funds or the settlor or beneficiary of such trust arrangement.

7. Add § 564.12, as follows:

§ 564.12 Accounts held by or established through intermediaries.

(a) Except as provided in paragraph (b) of this section, funds owned by a principal and invested in one or more accounts in the names of agents or nominees shall be added to any individual accounts held directly by the principal, and insured up to $100,000 in the aggregate.

(b) Notwithstanding any other provision of this Part, funds invested in one or more accounts by or through a deposit broker shall be added to any other deposits placed by or through that deposit broker and insured up to $100,000 in the aggregate. This paragraph shall apply to all accounts opened, funds placed in existing accounts, and renewals of existing accounts, where such opening, placement, or renewal occurs on or after October 1, 1984, except that it shall not apply until:

(1) Either October 1, 1985, or the maturity date of the account, whichever is later, with respect to renewals of time deposits in existence on March 26, 1984, provided that: (i) Only interests of persons in such accounts as of March 26, 1984, will be recognized for purposes of insurance coverage, and (ii) the identities and interests of such beneficial owners are reflected on the records of the insured institution by June 30, 1984;

(2) November 30, 1984, with respect to accounts which have no specified maturity date; and

(3) The maturity date of the corresponding loan, with respect to renewals of accounts established prior to October 1, 1984, and held by a person who is, with respect to such accounts, a deposit broker under § 561.2a(a)(2), only if such renewal is mandatory under the terms of the account agreement or trust agreement governing the rights and obligations of the trustee or agent.

(c) A loan servicer who receives loan payments and places or maintains such payments in an insured institution prior to remittance to the lender or other parties entitled to the funds shall, for insurance-of-accounts purposes, be considered an agent of each borrower.

(d) Funds held by a guardian, custodian, or conservator for the benefit of a ward or a minor under a Uniform Gifts to Minors Act, and invested in one or more accounts in the name of the guardian, custodian, or conservator, shall be added to any individual accounts of the ward or minor and insured up to $100,000 in the aggregate.

By Order of the Board of Directors, March 26, 1984.

Federal Deposit Insurance Corporation.

Hoyle L. Robinson,

Executive Secretary.

By Order of the Board, March 26, 1984.

Federal Home Loan Bank Board.

J. J. Finn,

Secretary to the Board.

[FR Doc. 84-[illegible] Filed 3-30-84; 8:45 am]

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EC- 224

EXAMINING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type Examining Circular	Subject Supervision of Banks Using Brokered Deposits

To: Deputy Comptrollers; District Administrators; Division Directors; and Examining Personnel

PURPOSE

This Circular establishes a uniform policy for supervision of banks using brokered deposits. It establishes the process for the close monitoring of brokered deposits and directs the specific supervisory action to be taken.

SCOPE

This policy applies to all national banks that use brokered deposits. This circular supersedes prior directives establishing parameters for monitoring brokered deposits. For guidance on treatment of brokered deposits in reports of examination refer to Examining Circular 221, dated April 11, 1984, which remains in effect.

POLICY

It is OCC policy to maintain an effective monitoring program for banks using brokered deposits and to take prompt supervisory action to curb unsafe or unsound reliance on or use of brokered deposits.

PROCEDURES

Monitoring:

Deputy Comptrollers (District) are responsible for the close monitoring of all banks that have total brokered deposits equal to or in excess of 5% of their total deposits. This monitoring program should include a review of the monthly reports required by the FDIC under its interim final rule, copy attached. This approach will be used to closely track the status of banks known to use brokered deposits and quickly identify banks that become new users or show increased reliance on brokered deposits.

In addition, the District's monitoring program should provide for detection of brokered deposit dependence from other sources of information, such as NBSVDS, reports of examination, correspondence or monthly progress reports required by formal administrative agreement. This information should immediately be relayed to the District Administrator along with a recommended plan for follow-up action.

Regional banks and those in Special Projects will receive oversight review by their respective Washington divisions. The Multinational Banking Department will directly monitor and follow-up on multinational banks which use brokered deposits.

Management Information System:

The District Administrator will maintain and update at least monthly a District Brokered Deposit Monitoring Report. The report should follow the format shown in Exhibit A and should include all banks with brokered deposits equal to or in excess of 5% of their total deposits. The report should segregate banks by supervisory office, including separate categories for Regional banks and banks in the Special Projects Program.

The District Administrator should designate a specific level of concern (Low, Moderate, High) for each monitored bank. The following guidelines should be considered in establishing the designated level of concern:

Low:

Volume of brokered deposits typically ranges from nominal to 10% of total deposits, but may be higher for certain banks engaged in special activities, such as a non-bank bank which uses brokered deposits to prudently fund consumer or credit card operations. The bank's funding policies are sound and provide for adequate spreads, backup sources of liquidity, and matched maturities with assets being funded. Overall portfolio quality is good. No evidence of abuse is apparent. Overall condition of bank is satisfactory (CAMEL Composite ordinarily "1 or 2").

Moderate:

Volume of brokered deposits is typically greater than 10% of total deposits, but ordinarily less than 15%. The bank's written policies and procedures soundly govern the use of brokered deposits. Maturities are generally matched. Alternative funding/liquidity sources are available to mitigate degree of reliance on brokered deposits. Little or no evidence of abuse exists. Brokered deposits are deployed in a reasonable manner and do not support high risk or otherwise criticized assets. Overall bank condition does not present a significant supervisory risk (CAMEL Composite does not exceed "3" unless amount of brokered funds is nominal).

High:

Volume of brokered deposits is generally greater than 15% of total deposits. An exception may be appropriate for certain banks engaged in special activities, such as a non-bank bank which uses brokered deposits to prudently fund credit card operations. Bank may lack written policies and procedures in funding area. High degree of reliance on brokered deposits is apparent. Bank may lack a strong core deposit base or have limited access to alternative funding sources. Mismatched maturities or negative trends in rate sensitive liabilities may exist. Possibly there is evidence of premium rates negatively impacting margins. Portfolio quality is weak and/or high risk in composition. Possibly evidence of abuse or misuse of brokered deposits exists. Overall bank condition is generally unsatisfactory to acceptable (CAMEL Composite typically "3" or greater).

In addition, the District Administrator should indicate the follow-up action to be taken or the specific reasons why further action is not necessary. For banks already under an administrative action the District Administrator should indicate if the document's provisions adequately address brokered funds given the bank's present reported level of use and recent trends.

EC- 224

EXAMINING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type Examining Circular

Subject Supervision of Banks Using Brokered Deposits

Reporting:

Quarterly, within 30 days from the date edited Call Report information is available from the NBSVDS, the District Administrator should submit the Brokered Deposit Monitoring Report to the Chief National Bank Examiner. The Chief National Bank Examiner will forward copies to other affected Washington units.

The District Administrator should promptly notify the Chief National Bank Examiner and, as appropriate, the Multinational and Regional Bank Supervision or Special Projects Divisions in the event of significant interim developments.

Supervisory Action:

If the level of concern is either unknown or known to be moderate or high, the District Administrator should take one or more of the following supervisory actions based on the level of brokered deposits held.

If the bank's most recently determined level of brokered deposits is:

5% to 10%:

Promptly verify the dollar amount of brokered deposits reported, determine use of deposits, current range of interest rates paid, volatility or maturity distribution, bank policies and procedures, future funding plans relative to brokered funds and any other pertinent data. If potential supervisory concerns are identified, a targeted examination should be conducted as soon as possible but not later than 45 days after identification.

10% to 15%:

Promptly verify the dollar amount and information described above. Send a letter to the Board of Directors expressing our concern about the volume and use of brokered deposits at the bank and our belief that corrective action may be necessary to reduce the risk they pose. If potential supervisory concerns are identified, proceed as above.

EC - 224

EXAMINING ISSUANCE

Comptroller of the Currency
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15% or Greater:

Proceed as in previous range, except conduct a targeted examination of the bank's use of brokered deposits, as well as its funding and liquidity areas to commence as soon as possible, but not later than 45 days after identification. If an examination was completed within the past 180 days and the level of brokered deposits has not significantly changed in the interim then a brief investigation should be made to verify that no additional supervisory concerns are present.

Further, the District Administrator should determine whether the bank should be:

- Requested to submit a contingency funding plan,
- Required to submit a plan for reducing its dependence on brokered funds,
- Placed under an administrative action and/or
- Placed on the Action Control System.

The District Administrator should include comments in the District Brokered Deposit Monitoring Report on the action taken and the reasons for it.

ORIGINATING OFFICE

Chief National Bank Examiner's Office, Commercial Examinations Division, Washington, D.C.
FTS 447-1165.

H. Joe Selby
Senior Deputy Comptroller
for Bank Supervision

Attachments

DISTRICT BROKERED DEPOSIT MONITORING REPORT

CHARTER NUMBER	BANK NAME	SUPERVIS OFFICE	BROKER DEPOSITS 3/31/84	BROKER DEPOSITS CURRENT	LEVEL OF CONCERN	COMMENTS	FURTHER ACTION
						BANKS MONITORED BY SPECIAL PROJECTS	
X	BANK, N.A. CITY, STATE	DIST	10800M 22.45	9800M 20.0	HIGH	CONSISTS OF 98 DEPOSITS OF WHICH 6.4MM ARE FIXED RATE. MATURITIES RANGE FROM 5/84 TO 12/85. DEPOSITS USED TO FUND HIGH REAL ESTATE LOANS WITH 5 YEAR BULLET MATURITIES AND USED AS A SOURCE OF SHORT TERM LIQUIDITY BANK PLANS TO ESTABLISH A LOCAL MONEY DESK TO SOLICIT LARGE DEPOSITS DIRECT. CONVERSION FROM BROKER DEPENDENCE TO DIRECT DEPOSITS IS EXPECTED TO TAKE SIX MONTHS. ACTION IS A DIRECT RESULT OF FDIC INSURANCE RULING. ACTIVITY IS MONITORED BY BANK CASHIER WHO IS DEEMED KNOWLEDGABLE AND EXPERIENCED. DETAILED POLICY IS IN PLACE. BANK HAS MOU IN FORCE.	BANK MONITORED VIA SPECIAL PROJECTS-MONTHLY REPORTING REQUIRED. LETTER TO BE SENT REQUESTING PLAN TO REDUCE RELIANCE BY OCT. 1, 1984
X	ABC NATIONAL BANK CITY, STATE	DIST	11725M 31.90	17200M 40.00	HIGH	FUNDS SUPPORT SHORT TERM AND MEDIUM TERM LOANS. MATURITIES ARE NOT MATCHED. MATURITIES SPREAD BETWEEN 5/84 AND 4/90 WITH MAJORITY DUE WITHIN 1 YEAR. PLAN NOT TO RENEW THEM. WILL REPLACE WITH LOCAL DEPOSITS AND REDUCTION OF BALANCE SHEET THROUGH LOAN SALES. HAVE A $2MM LINE OF CREDIT AS A CONTINGENCY FUNDING SOURCE. CONSENT ORDER HAS BEEN AMENDED TO REQUIRE REDUCED DEPENDENCE ON BROKERED FUNDS.	BANK MONITORED VIA SPECIAL PROJECTS-WEEKLY REPORTS
X	XYZ NATIONAL BANK CITY, STATE	DIST	800M 6.18	200M 5.2	MODERATE	FUNDS USED FOR SHORT TERM COMMERICAL LOANS AND LIQUID ASSETS. MATURITIES ARE MATCHED. $1,3MM IS ARBITRAGED AT OTHER BANKS. USE OF FUNDS TO BROKERED DEPOSITS BY 12/84. BALANCE HAS BEEN STEADILY REDUCING SINCE 9/83. NO FORMAL POLICIES ARE IN PLACE.	BANK MONITORED VIA SPECIAL PROJECTS-MONTHLY REPORTS
						BANKS SUPERVISED BY FIELD OFFICE	
X	NATIONAL BANK CITY, STATE	F.O.	1400M 3.11	4200M 10.00	MODERATE	USING FUNDS TO HELP REPLACE 10MM IN PUBLIC FUNDS THAT IS TO RUN OFF IN 90-120 DAYS. WANT TO FREE UP SECURITIES PORTFOLIO FROM PLEDGING REQUIREMENTS. PLAN TO NEED BROKERED FUNDS FOR NEXT 4-5 MONTHS, PROBABLY NOT TO EXCEED 5MM OR 12% OF DEPOSITS. LIQUIDITY APPEARS ADEQUATE.	MATTER TO BE EVALUATED AT EXAM IN JUNE, 1984
X	FIRST NATIONAL BANK CITY, STATE	F.O.	1800M 10.18	1200M 7.00	LOW	RECENTLY ACQUIRED FOUR BRANCHES. FUNDS USED TO FULFILL COMMITMENTS UNTIL SURPLUS DEPOSITS FROM ACQUISITONS WERE RECEIVED. LOANS TO DEPOSIT ARE NOW AT ONLY 30%. EXPECT BROKER FUNDS TO RUN OFF AS WILL QUOTE A BELOW MARKET PRICE TO DISCOURAGE RENEWALS.	MONTHLY REPORTING

EXHIBIT A

Rules and Regulations

Federal Register
Vol. 49, No. 130
Thursday, July 5, 1984

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR PART 304

Reporting Requirements on Deposits Placed by Deposit Brokers and Financial Institutions

AGENCY: Federal Deposit Insurance Corporation.

ACTION: Interim final rule.

SUMMARY: The Federal Deposit Insurance Corporation ("FDIC") has adopted an interim final regulation requiring each FDIC-insured bank with combined brokered deposits and fully insured deposits of financial institutions in excess of either the bank's total capital and reserves or five percent of the bank's total deposits to report holdings of such deposits to the FDIC for every month in which such excess exists. The purpose of this regulation is to provide the FDIC with more frequent information on each FDIC-insured bank's involvement with brokered deposits and fully insured deposits of financial institutions.

The FDIC has issued this regulation without the normal comment period because it deems the misuse of such deposits by the depository institutions industry to be of significant danger to the federal deposit insurance system to warrant immediate action. In order to obtain public comment on the matters addressed in this regulation, however, the FDIC has issued this rule on a temporary basis with an expiration date of January 15, 1985. The FDIC has asked that comments be provided to the FDIC within sixty days after the publication date of the interim final rule. It is anticipated that before January 15, 1985, the FDIC will issue a final rule on this topic which will be reflective of the public comments received during the comment period.

EFFECTIVE DATE: August 6, 1984, with the first required filing, if applicable, within ten days after July 31, 1984. Comments must be received by September 4, 1984.

ADDRESS: Comments should be directed to Hoyle L. Robinson, Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, D.C. 20429. Comments may be delivered to Room 6108 on weekdays between 8:30 a.m. and 5:00 p.m.

FOR FURTHER INFORMATION CONTACT: Robert F. Storch, Examination Specialist, or Jesse C. Snyder, Assistant Director, Federal Deposit Insurance Corporation, Division of Bank Supervision, (202) 389-4781 or 389-4141, 550-17th Street, NW., Washington, D.C. 20429.

SUPPLEMENTARY INFORMATION:

Background

On March 28, 1984, the FDIC issued a joint regulation with the Federal Home Loan Bank Board limiting the insurance coverage of funds placed with an insured depository institution either by or through a deposit broker. 49 FR 13003 (1984). The regulation was to take effect on October 1, 1984. The FDIC promulgated the brokered deposits regulation because it deems deposit brokerage to be a misuse of the federal deposit insurance system and a significant threat to the federal deposit insurance fund. The Federal Register publication on the brokered deposits regulation explains in detail the FDIC's concerns about deposit brokerage and provides ample data to show that the use of brokered deposits has been extremely costly to the FDIC in handling recent bank failures and poses a growing threat in troubled institutions. *Id.*

On the same day the FDIC issued the brokered deposits regulation, court action was brought to nullify the regulation. On June 20, 1984, the Federal District Court for the District of Columbia ruled that the regulation was illegal, concluding that the FDIC (and the Federal Home Loan Bank Board) had exceeded statutory boundaries in imposing insurance limitations on brokered deposits. The FDIC intends to pursue an appeal of the Court's decision. In the meantime, deposit brokerage continues to present a clear and present danger to the insurance system as deposit brokers continue to exploit and abuse federal deposit insurance coverage. Moreover, many financial institutions, such as credit unions, place fully insured funds directly with banks based solely on the rate of interest paid without regard to the financial condition of the institutions. This, too, presents a serious threat to the deposit insurance system.

For these reasons, it is necessary that the FDIC accumulate more frequent information from insured banks on brokered deposits and fully insured deposits placed directly by financial institutions. At present the FDIC obtains limited information on brokered deposits from quarterly Reports of Condition from insured banks, but the speed with which large dollar amounts of brokered funds are transmitted requires increased monitoring of such activity. No information is presently collected on full insured deposits placed by financial institutions. With this monthly information the FDIC hopes to mitigate somewhat the harms caused by such deposits by determining on a regular basis what banks are using such funds and to what use those funds are being put. This increased monitoring effort, however, will not solve the problems posed; it will merely assist the FDIC in identifying institutions which may be developing or experiencing financial difficulties. A permanent solution to the problems caused by deposit brokerage and by the direct placement of fully insured funds by financial institutions is yet to be put in place.

Once the FDIC obtains information required to be reported by this section it will review the financial soundness of the banks filing such reports. For banks exhibiting problems of safety or soundness, the FDIC will take the appropriate regulatory actions under section 8 of the Federal Deposit Insurance Act, 12 U.S.C. 1818. If special examinations are necessary to determine whether safety or soundness problems exist, the FDIC will perform such examinations pursuant to the authority found in section 10(b) of the Federal Deposit Insurance Act, 12 U.S.C. 1820(b). Banks which fail to comply with this regulation will be subject to fines prescribed by the Federal Deposit Insurance Act.

Explanation of the Regulation

The regulation is in the form of an addition to Part 304 of the FDIC's regulations, "Forms, Instructions, and Reports," 12 CFR Part 304. It requires that all insured banks report to the FDIC regional director in the FDIC region where the bank is located the amount of brokered deposits and fully insured deposits placed directly by financial institutions held by the bank at the end of each month. The report is required, however, only if the sum of such deposits at the end of a given month is in excess of either the bank's total capital and reserves or five percent of the bank's total deposits. No report is necessary when the total of a bank's brokered deposits and fully insured deposits placed by financial institutions at the end of a month is not greater than either of the specified dollar amounts. When such reports are required they must be filed within ten days after the end of the month in which the amount of such deposits exceeds either the bank's total capital and surplus or five percent of total deposits. The definitions of the key terms in the regulation are the same as those found in the *Instructions for Consolidated Reports of Condition and Income*.

The regulation becomes effective August 6, 1984, with the first required filing, if applicable, within ten days after July 31, 1984.

Procedural Requirements

The FDIC deems it essential that this regulation be implemented as soon as possible. This is so because deposit brokerage and the direct placement of fully insured deposits by financial institutions have resulted in significantly increased costs to the FDIC in handling failed and failing insured banks. It is feared that the use of brokered deposits by marginal institutions will escalate as a result of the United States District Court's ruling that the deposit brokerage regulation is unlawful. Monthly reporting by insured banks using a significant amount of brokered deposits and fully insured deposits of financial institutions will assist the FDIC in identifying banks which may be experiencing or developing safety and soundness difficulties. For these reasons, the FDIC finds good cause for not publishing this regulation as a proposed rule with the opportunity for public comment. Hence, the FDIC Board of Directors has determined that adherence to the public notice and participation requirements of section 553(b) of title 5 of the United States Code would be impracticable and contrary to the public interest. 5 U.S.C. 553(b). In order to obtain public comment on the subject matter of this rule, however, the FDIC has issued this regulation on a temporary basis with an expiration date of January 15, 1985. The FDIC hereby solicits comments on the substance of this interim regulation for sixty days after the publication of the rule in the **Federal Register**. Comments are specifically requested on the adequacy of monthly reports, the scope of the information to be reported, the means of reporting the information and steps to be taken once the reported information is assimilated.

In accordance with the Regulatory Flexibility Act (5 U.S.C. 601–612), the Board of Directors hereby certifies that the rule will not have a significant economic impact on a substantial number of small entities. The rule only establishes a monthly reporting requirement on all FDIC-insured banks with brokered deposits and deposits placed directly by financial institutions that exceed specified levels and does not affect or limit a bank's operations. Inasmuch as the data required by this reporting regulation are currently collected by banks for quarterly reports, the additional burden placed upon most institutions by this requirement is not significant. Also, because the total of such categories of deposits does not yet constitute a significant portion of total deposits of most insured institutions, the rule's reporting requirement is not expected to affect a significant number of banks. The monthly reporting requirement contained in this rule was submitted to the Office of Management and Budget for review pursuant to section 3504(h) of the Paperwork Reduction Act (44 U.S.C. 3504(h)).

The FDIC is promulgating this regulation under its authority granted in sections 7, 9 and 10(b) of the Federal Deposit Insurance Act, 12 U.S.C. 1817, 1819 and 1820(b).

Lists of Subjects in 12 CFR Part 304

Administrative practice and procedure; Bank deposit insurance; Banks, banking; Federal Deposit Insurance Corporation; Foreign banks, banking; Reporting and recordkeeping.

PART 304—FORMS INSTRUCTIONS AND REPORTS

Accordingly, the FDIC hereby amends Part 304 of the CFR as set forth below.

1. The authority citation for Part 304 is amended to read as follows:

Authority: 12 U.S.C. 1817, 1818, 1819, 1820.

2. Section 304.4 is added as follows:

§ 304.4 Report of brokered deposits and deposits placed by financial institutions.

(a) *Filing*. Within ten days after the end of each month, each insured bank shall report to the appropriate FDIC regional director the bank's total amount of brokered deposits and fully insured deposits placed directly by financial institutions as of the end of that month, if the sum of such deposits was in excess of either the bank's total capital and reserves or five percent of the bank's total deposits on such date. If such report is required by this section, it must be in letter form, signed by an executive officer of the bank, and must include data on the bank's total assets, total loans, total deposits, total capital and reserves and the range of rates paid on brokered deposits and deposits placed directly by financial institutions during the reporting month. Figures may be rounded to the nearest thousand.

(b) *Definitions.* For purposes of this section:

(1) The terms "appropriate FDIC regional director" means the FDIC regional director in the FDIC region in which the insured bank is located.

(2) The terms "brokered deposits," "total deposits," "total assets," and "total loans" shall have the same meanings as those found in the *Instructions for Consolidated Reports of Condition and Income.*

(3) The term "total capital and reserves" means: (i) For banks other than savings banks, the sum of "total equity capital" and the "allowance for loan and lease losses," as those terms are defined in the *Instructions for Consolidated Reports of Condition and Income,* and (ii) for savings banks (mutual and stock), the sum of "total capital accounts" and the "allowance for possible loan losses" on real estate loans and all other loans, as those terms are defined in the Savings Banks Report of Condition (Form 8040/18), which is described in § 304.3(n) of this part.

(4) The term "fully insured deposits placed directly by financial institutions" means the time and savings deposits up to $100,000 (other than deposits placed by or through a deposit broker) deposited directly by any state or federally insured depository institution. This definition does not include situations where an insured depository institution has uninsured funds (excluding accrued and unpaid interest) placed with the bank.

(c) *Effective and termination dates.* The first report required under this section shall be filed within ten days after July 31, 1984. This section shall be effective until January 15, 1985.

By Order of the Board of Directors, July 3, 1984.

Federal Deposit Insurance Corporation.

Hoyle L. Robinson,

Executive Secretary.

[FR Doc. 84-[illegible] Filed 7-3-84; 8:45 am]

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EB-84-10

EXAMINING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type Examining Bulletin

Subject Brokered Deposits-
Premature Redemptions

TO: Deputy Comptrollers (District), District Administrators,
Department and Division Heads, and All Examining Personnel

PURPOSE

Examining personnel should be alert to the recently issued FDIC bank letter (BL-34-84) which cautions insured banks against agreeing in advance to "repurchase" certificates of deposit issued through deposit brokers. It also provides guidance to examiners who encounter such practices in the course of their examinations of national banks.

BACKGROUND

The attached FDIC bank letter was issued to stem an apparent emerging practice of some insured financial institutions to accept brokered deposits with a contractual condition that violates both the FDIC's regulations and the Federal Reserve Board's position that banks may not agree in advance to pay a time deposit before maturity.

POLICY

OCC considers the practice of agreeing to repurchase certificates of deposit in advance as a violation of 12 CFR 329.4(f) and Regulation Q and will enforce compliance by national banks.

PROCEDURE

Until the pending appeal involving the brokered deposits rule of the FDIC and FHLBB is resolved or other regulatory or legislative action is taken on this matter, examiners should determine during the course of their examinations if such conditions have been agreed to by national banks which use brokered deposits.

Date December 5, 1984

EB-84-10

EXAMINING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type Examining Bulletin	Subject Brokered Deposits- Premature Redemptions

If such practices are noted, the examiner-in-charge should inform the bank to cease the practice immediately, cite the violation in the report of examination and alert the District Office which is responsible for monitoring brokered deposit activity pursuant to Examining Circular No. 224.

ORIGINATING OFFICE

Chief National Bank Examiner, Commercial Examinations Division.

John F. Downey

John F. Downey
Chief National Bank Examiner

Attachment

Date December 5, 1984

FDIC
Federal Deposit Insurance Corporation
Washington DC 20429

Division of Bank Supervision

BROKERED DEPOSITS

BL-34-84
October 19, 1984

TO: CHIEF EXECUTIVE OFFICERS
OF ALL INSURED BANKS

SUBJECT: Advance Consent to Premature Redemption of Brokered Deposits

On March 26, 1984, the FDIC Board of Directors issued a regulation, effective October 1, 1984, limiting insurance coverage of brokered deposits. The Board took that action because of the threat to the deposit insurance system and the competitive injury to well-run banks stemming from the misuse of such funds by some banks and thrifts. In June 1984, a United States District Court ruled that the brokered deposits regulation was unlawful and enjoined the FDIC from implementing it.

The FDIC has appealed the District Court's ruling to the United States Court of Appeals. It is uncertain when the court will render judgment on the appeal. In the interim, as required by the District Court's decision and order, the brokered deposits regulation is not effective. Hence, there is no current change in FDIC insurance coverage of brokered deposits. In this respect, the FDIC has received numerous questions on whether October 1, 1984, might be reinstated as the effective date of the regulation if the appellate court ultimately rules that the regulation was lawful from its issuance date. The FDIC does not intend to address this issue until a decision is reached by the Court of Appeals.

In this connection, the FDIC is aware that some financial institutions may be accepting brokered deposits with the contractual condition that they will "repurchase" (or prematurely redeem) such deposits if the insuring agencies (the FDIC and the Federal Savings and Loan Insurance Corporation) prevail in the pending brokered deposits litigation. Such a provision in a time deposit agreement with an insured non-member bank violates the FDIC's regulations, which provide that an insured non-member bank may not give advance consent to a request for the premature withdrawal of a time deposit (12 C.F.R. Section 329.4(f)). Moreover, the FDIC believes that this practice would be highly dangerous and would likely be deemed an unsound and unsafe banking practice, warranting a formal cease-and-desist proceeding. The legal staff of the Board of Governors of the Federal Reserve System also has taken the position that, under Regulation Q, a member bank may not agree in advance to pay a time deposit before maturity (*Federal Reserve Reg. Ser.*, Section 2-531).

All insured banks, therefore, are cautioned against agreeing in advance to "repurchase" certificates of deposit issued through deposit brokers.

Robert V. Shumway
Director, Division of
Bank Supervision

Distribution: All Insured Banks